INDIAN ECONOMY

— ITS DEVELOPMENT EXPERIENCE

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Part - I: Summary Statistics

I. GNP per capita in US dollars (2018)

– High income economies	44,166
– Upper middle income economies	8,859
– Lower middle income economies	2,245
– Low income economies	790
– India	2,020
– China	9,470

II. HDI, 2018 (HDI calculated for 189 countries)

– Norway (first rank)	index value 0.953
– Switzerland (second rank)	index value 0.944
– India (130th rank)	index value 0.640
– Niger (last rank)	index value 0.354

III. GII, 2017

- Values of GII range from an average of 0.270 for Europe and Central Asia to 0.569 for Sub-Saharan Africa and from an average of 0.170 for the very high human development group to 0.586 for the low human development group.
- India with GII value of 0.524 in 2017 ranks 127th.

IV. Multidimensional Poverty Index (MPI)

- In most of the countries falling in the medium and low human development category, more than one-third of the population suffers from multidimensional poverty. In fact, in countries falling in low human development category, more than half of the population suffers from multidimensional poverty.
- In India, 27.5 per cent of the population, *i.e.,* as many as 36.4 crore people suffered from multidimensional poverty. Not only this, 8.6 per cent of the population lives under conditions of severe poverty (reference year 2015-16).

V. Growth and Environmental Degradation

- According to a World Bank Report published in June 2013, the total cost of environmental degradation in India is about ₹ 3.75 trillion annually, equivalent to 5.7 per cent of GDP in 2009.
- According to the same Report, over the period 1953-2009, damages from natural disasters stood at ₹ 150 billion a year on average (at constant 2009 prices).
- Of the cumulative 1,169.1 billion metric tonnes of carbon dioxide emissions in the world over the period 1850 to 2005, high income countries accounted for as much as 750 billion metric tonnes (*i.e.,* 64.2 per cent) while the share of low income countries was just 24.0 billion metric tonnes (2.1 per cent) and the share of middle income countries was 395.1 billion metric tonnes (34.0 per cent).

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1 Chapter

ECONOMIC GROWTH, DEVELOPMENT AND UNDERDEVELOPMENT

Today, economic growth is everybody's concern and in such a milieu, growth theory has received particular attention of economists. Yet surprisingly, there is no consensus on the definition of the term. Different economists have used the term 'economic growth' to convey different meanings. In some cases the concepts differ in essence, whereas in others only in emphasis. Some other economists are of the view that the term 'economic growth' is very much obvious and there is no need to frame a precise definition of it. Thus, quite often no distinction is made between 'economic growth' and 'economic development' and the two terms are used interchangeably. Others feel that clear and unambiguous definitions are a prerequisite to any precise analysis. Underlying the difficulties which most social scientists face in the absence of precise definitions, Ronald A. Shearer stated, "The literature of social sciences is a testimony to the errors; unnecessary confusions and prolonged debates which can result from an ambiguity on the level of basic conceptualisation."[1] There is certainly weight in Shearer's observations. We also feel that to avoid ambiguity, it is better to identify economic growth in terms of some measurable criteria.

In this chapter, we propose to address the following issues:

- The concept of economic growth
- The concept of economic development
- Growth and development: A contrast in concepts
- Meaning and indicators of underdevelopment
- Common characteristics of underdeveloped/ developing countries.

THE CONCEPT OF ECONOMIC GROWTH

Economic growth may be defined as a rate of expansion that can move an underdeveloped country from a near subsistence mode of living to substantially higher levels in a comparatively short period of time, *i.e.*, in decades rather than centuries. For nations already advanced economically, it will mean a continuation of existing rates of growth. ***Historically, rapid economic growth has been accompanied by greater industrialisation. But more accurately the process of economic growth can be described in terms of greater commercialisation of economic activities.***

Rise in gross domestic product. According to some economists, economic growth is a process whereby an economy's gross domestic product (GDP) increases over a long period of time.[2] In this context, it is necessary to distinguish between gross national product (GNP) and gross domestic product (GDP). In a closed economy, no distinction is required to be made between gross national product and gross domestic product (GDP), whereas in an economy open to foreign trade, national product may be greater or less than domestic product depending upon the net inflow or outflow of income. A country may record an increase in its GNP if its people have invested massive capital outside the country and earn big profits therefrom. But this does not mean that the economy has developed. Therefore, the only rational approach to the problem will be to differentiate the term GDP from the term GNP in the context of economic growth. Obviously, of the two variables, GDP will a more accurate picture of economic growth as compared to GNP. In this context, it is pertinent to mention that the increase in GDP must be steady and prolonged. A short period increase, as occurs within the boom period of a trade cycle, cannot be accepted as growth.

Rise in per capita product. However, it is not correct to define economic growth in the above manner. The reason is that if the population in a country grows faster than GDP, product per capita (or income per capita) will decline. Obviously, this cannot be termed economic growth. Accordingly, many economists have defined economic growth as a sustained increase in per capita product (or income). This, in fact, is the most satisfactory approach to economic growth. Accordingly, in our study of India's problems of growth in this book, ***we also define economic growth in terms of a rise in per capita product (or income).*** However, it needs to be emphasized here that it is also necessary to focus on the structural changes that occur within the country over a period of time because in many cases these changes are of greater importance than some increase in per capita product. Charles Bettelheim has pertinently remarked that, in planning for economic growth, "the aim should be not quantitative change (large production)

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only, but qualitative change too ***(i.e., higher productivity of labour).*** Only on the basis of such qualitative change can an economy as a whole rise to higher level."[3]

THE CONCEPT OF ECONOMIC DEVELOPMENT

Till the 1960s, the term 'economic development' was often used as a synonym of 'economic growth' in economic literature. Now, economic development is no longer considered identical with economic growth. It is taken to mean growth *plus* progressive changes in certain crucial variables which determine the well-being of the people. There are qualitative dimensions in the development process which may be missing in the growth of an economy expressed in terms of an increase in the national product or the product per capita. Development economists are no longer impressed by the growth performance of a country which gets reflected in the rise in its GDP (or GNP); they now concentrate more directly on the development process. Mahbub ul Haq, a leading Pakistani economist has remarked, "***the problem of development must be defined as a selective attack on the worst forms of poverty. Development goals must be defined in terms of progressive reduction and eventual elimination of malnutrition, disease, illiteracy, squalor, unemployment and inequalities.*** We were taught to take care of our GNP because it would take care of poverty. Let us reverse this and take care of poverty because it will take care of the GNP. In other words, let us worry about the content of GNP even more than its rates of increase."[4]

The Traditional Approach

In the present-day development economics, one finds broadly two main approaches to the concept of economic development. The first one often known to be the *traditional* approach, defines development strictly in economic terms. For the exponents of traditional approach ***economic development implies a sustained annual increase in GNP (or GDP) at rates varying from 5 to 7 per cent or more together with such alteration in the structure of production and employment that the share of agriculture declines in both, whereas that of the manufacturing and tertiary sectors increases.*** The policy measures thus suggested are the ones which induce industrialisation at the expense of agricultural development. Objectives of poverty elimination, economic inequalities reduction and employment generation are mentioned in passing reference only and in most cases, it is assumed that rapid gains in overall growth in GNP or per capita national (or domestic) product would trickle down to people in one form or the other. ***This is known as the 'trickle down' effect of economic growth.***

The New View of Economic Development

Having realised that about 40 per cent of the developing world's population had not benefited at all from economic growth during the 1950s and 1960s, an increasing number of economists called for the rejection of the narrow definition of economic development. During the 1970s, they redefined the concept of economic development in terms of the reduction or elimination of poverty, inequality and unemployment in the context of a growing economy. In this phase, "Redistribution with Growth" became the popular slogan. Talking in this framework, Charles P. Kindleberger and Bruce Herrick argued, ***"Economic development is generally defined to include improvements in material welfare, especially for persons with the lowest incomes, the eradication of mass poverty with its correlates of illiteracy, disease and early death, changes in the composition of inputs and outputs that generally include shifts in the underlying structure of production away from agricultural towards industrial activities,*** the organisation of the economy in such a way that productive employment is general among the working age population rather than the situation of a privileged minority; and the correspondingly greater participation of broadly based groups in making decisions about the directions, economic and otherwise, in which they should move to improve their welfare."[5]

Dudley Seers posed the basic questions about the meaning of development in the right perspective when he asserted, "The questions to ask about a country's development are therefore: What has been happening to poverty? What has been happening to unemployment? What has been happening to inequality? If all three of these have declined from high levels, then beyond doubt this has been a period of development for the country concerned. If one or two of these central problems have been growing worse, especially if all three have, it would be strange to call the result 'development' even if per capita income doubled."[6]

In light of the environmental destruction that is taking place all over the world presently in the pursuit of the objective of growth, protection of environment is now regarded as an integral part of development. As pointed out by Dreze and Sen, "In the broader perspective of seeing development in terms of promoting substantive human freedom, fighting poverty and being responsible about the environment cannot but be closely linked... Indeed, important components of human freedoms – and crucial ingredients of our quality of life – are thoroughly dependent on the integrity of the environment, involving the air we breathe, the water we drink, and the epidemiological surroundings in which we live. ***The opportunity to live the kind of lives that people value – and have reason to value – depends among other things on the nature and robustness of the***

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environment. In this sense, development has to be environment-inclusive...."[7]

GROWTH AND DEVELOPMENT: A CONTRAST IN CONCEPTS

As stated earlier, in recent literature the term ***economic growth*** refers to increases over time in a country's real output of goods and services — or more appropriately product per capita. Output is generally measured by gross or net national product, though other measures could also be employed. The term ***economic development***, in contrast, is more comprehensive. It implies progressive changes in the socio-economic structure of a country. Viewed in this way, economic development involves a steady decline in agriculture's share in GNP and a corresponding increase in the share of industries, trade, banking, construction and services. This transformation in economic structure is invariably accompanied by a shift in the occupational structure of the labour force and an improvement in its skill and productivity. Charles P. Kindleberger rightly asserts that whereas economic growth merely refers to a rise in output, economic development implies changes in technological and institutional organisation of production as well as in distributive pattern of income. Compared to the objective of development, economic growth is easy to realise. By mobilising larger resources and raising their productivity, output level can be raised. The process of development is far more extensive. Apart from a rise in output, it involves changes in the composition of output as well as a shift in the allocation of productive resources so as to ensure social justice.

In some of the underdeveloped countries, the process of economic growth has been accompanied by economic development. This, however, is not necessary. It is quite probable that a country produces more of the same type of goods and services, to keep up with a growing population, while basic structure of the economy remains intact. In a well-known book on *Liberia*, Robert Clower had observed that in spite of the fact that the various concessions to foreign firms induced exports in a big way and resulted in a considerable increase in gross national product, there was virtually no complementary development in other sectors of the economy. The institutional set-up of the country essentially remained unaltered in this phase of growth. Further, the benefits of this growth went almost exclusively to a privileged few, while the vast majority of the country's people remained completely unaffected. Clower thus calls it "***growth without development.***"[8] Hence, Singer asserts, "for developing countries it is not difficult to demonstrate from numerical models, given their high rates of population increase, increasingly capital-intensive technology, the technological monopoly of the industrialised countries and their limited resources, that widespread 'trickle down', let alone the creation of social welfare states, is most unlikely in the normal context of purely economic growth."[9] However, in this context, it must be remembered that ***development without growth is inconceivable. A substantial rise in a country's GNP is required before it can hope to expand its industries, financial institutions, trade, public utilities, and government administration.*** Nowhere in the world has the occupational distribution of population changed in the absence of growth.

Emphasizing the importance of economic growth for achieving development, Jean Dreze and Amartya Sen have stated, "Economic growth is indeed important, not for itself, but for what it allows a country to do with the resources that are generated, expanding both individual incomes and the public revenue that can be used to meet social commitments."[10]

Most of the underdeveloped countries of today have a colonial past and their growth pattern is quite similar in many respects. The essence of this pattern of growth is dualism. ***Dualism refers to coexistence of developed and underdeveloped sectors in a country's economy side-by-side. In such an economy, one sector or subsector experiences perceptible growth, while the rest of the economy does not.*** Income generated by this growth in the past was shared by the representatives of the colonial power and by a small segment of the native population. Dualistic growth in a great number of countries has completely bypassed those areas and people who contributed nothing to the export economy.[11] In the absence of any connection with the growing sectors of the economy, these self-sufficient subsistence societies had suffered a long period of stagnation.

Political colonialism which could exclusively be blamed for enclave growth in backward countries has now disappeared, but its imprints on the economies of Asian, African and Latin American countries are still visible. It is distressing to note that ***even modern growth processes leave large segments of the population completely untouched. Former World Bank President Robert McNamara had estimated that about 40 per cent of the developing world's population did not benefit at all from the economic growth during the 1950s and 1960s.***[12] This experience was rather frustrating to multitudes of population. It also led to the adoption of an alternative conception of economic development. This viewpoint is generally referred to as the basic needs approach. This approach emphasizes that mere economic growth (even if accompanied by an equitable distribution of income) cannot meet the basic needs of the people. Consequently, ***"policies must be***

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implemented to ensure a rising and properly distributed supply of goods, both private and public, if basic needs are to be met."[13]

UNDERDEVELOPMENT: MEANING AND INDICATORS

Since the end of the World War II, economists have taken particular interest in the problems of relatively backward economies, and yet there is no definition of underdevelopment which will be universally acceptable. It is also difficult to classify different regions of the world into 'developed' and 'underdeveloped'. In fact, there are vast differences in the natural and human resources of different countries. Levels of capital formation, technological knowledge and economic organisation also differ considerably. All these differences are of such a magnitude that it does not seem possible to classify countries into developed and underdeveloped on their basis. USA, UK and Germany are all richly endowed with natural resources and all of them are classified as developed countries. However, the countries in Latin America and the Middle East are classified as underdeveloped in spite of the presence of large mineral resources. Density of population is high in India, Bangladesh, Pakistan, Indonesia, etc., whereas it is distinctly less in Latin American and African countries. However, all these countries are classified as underdeveloped. Therefore, density of population also cannot be relied upon to assess the degree of underdevelopment.

Occupational Distribution and Underdevelopment

In debates on problems of economic underdevelopment, occupational distribution of population is often mentioned as an objective criterion to divide countries between developed and underdeveloped. No doubt it is a useful criterion; at the same time from the point of view of analytical rigour, it is not completely reliable. It is widely held that *the countries in which the primary sector (i.e., agriculture, forestry, animal husbandry, etc.), provides employment to a large proportion of labour force, are underdeveloped. This notion has certainly an objective basis.* Most of the poor countries are essentially agricultural and even if some industries have been established in these countries, their impact is yet to be felt on the socio-economic life of the people. India, Nepal, Bangladesh, Pakistan and Tanzania fall in this category. In contrast, Mexico, Chile, Brazil and Argentina, are not agrarian economies, yet these countries are underdeveloped though the degree of underdevelopment is not exactly the same as in essentially agrarian economies. The occupational distribution of population and the sectoral distribution of national income are surely the indicators of the direction of economic change but they may not always correctly indicate the level of development achieved in a particular country.

Low Per Capita Income as an Indicator of Underdevelopment

The UN experts have defined an underdeveloped country as the one in which per capita real income is low when compared with the per capita real income of the USA, Canada, Australia and Western Europe.[14] This definition has focused its attention on the relatively lower levels of real income per capita in Afro-Asian and Latin American countries.

Natural resources of a country act as a limiting factor in economic development. Man by his ingenuity can develop productive forces, but poor natural resources of a region will always prove to be a serious obstacle to widespread industrial activity. Therefore, it is quite possible that a country fails to reach the European level of affluence, though it has harnessed all of its productive resources. Real income per capita in such a country may be lower than in the West European countries, yet it cannot be characterised as underdeveloped by any logic.

Moreover, we cannot treat a country as developed merely because its per capita income is comparable to that of the USA or Australia. Joan Robinson rightly asserts, "For several of the Arab States, GNP per capita suddenly

Box 1.1

Economic Growth, Development and Underdevelopment

Economic Growth

'Economic growth' refers to increase over time in a country's real output of goods and services – or more appropriately product per capita.

Economic Development

'Economic development' implies progressive changes in the socio-economic structure of a country. Further, development goals are defined in terms of progressive reduction in unemployment, poverty and inequalities.

Economic Underdevelopment

An underdeveloped country is characterised by a low level of per capita income. The Indian Planning Commission defines an underdeveloped country as one which is characterised by the coexistence of unutilised or underutilised manpower and of unexploited natural resources.

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jumped to levels which exceed that of the richest Western States, yet in these countries are found some of the poorest and least developed communities in the world."[15] This clearly indicates that underdevelopment or development of a country or a region may not always be reflected in its per capita national product or the average living standard.

Poverty Based Concept of Underdevelopment

Modern development economists now define development as a process involving elimination of poverty, income inequalities and unemployment. In this framework, underdevelopment is a situation characterised by the worst kinds of deprivation. Todaro, while defining underdevelopment in terms of poverty, goes beyond narrow economic criteria when he states, "Underdevelopment is a real fact of life for more than 3 billion people in the world — a state of mind as much as a state of national poverty."[16] Denis Goulet provides a forceful portrayal of underdevelopment in terms of poverty. He states, "Underdevelopment is shocking: the squalor, disease, unnecessary deaths, and hopelessness of it all! No man understands if underdevelopment remains for him a mere statistics reflecting low income, poor housing, premature mortality or underemployment. The most emphatic observer can speak objectively about underdevelopment only after undergoing, personally or vicariously, the 'shock of underdevelopment'. This unique culture shock comes to one as he is initiated to the emotions which prevail in the 'culture of poverty'. The reverse shock is felt by those living in destitution when a new self-understanding reveals to them that their life is neither human nor inevitable... The prevalent emotion of underdevelopment is a sense of personal and societal impotence in the face of disease and death, of confusion and ignorance as one gropes to understand change, of servility toward men whose decisions govern the course of events, of hopelessness before hunger and natural catastrophe. Chronic poverty is a cruel kind of hell; and one cannot understand how cruel that hell is merely by gazing upon poverty as an object."[17]

Development Potential and Underdevelopment

According to Jacob Viner, development potential of a country is a much better criterion to judge the extent of its underdevelopment. Therefore, he defines an underdeveloped country as the one "which has good potential prospects for using more capital or more labour or more available natural resources, or all of these, to support its population on a higher level of living, or if its *per capita* income level is already fairly high, to support a larger population on a not lower level of living."[18] Definition of an underdeveloped country given by the Indian Planning Commission in the First Five Year Plan is akin to the one given by Jacob Viner.

The Indian Planning Commission defines an underdeveloped country as "one which is characterised by the coexistence, in greater or less degree, of unutilised or underutilised manpower on the one hand, and of unexploited natural resources on the other."[19]

The definition of underdevelopment given by Jacob Viner and the Indian Planning Commission appears to be quite scientific and logical as it focuses its attention on a basic characteristic of underdeveloped countries – their development potential.

COMMON CHARACTERISTICS OF UNDERDEVELOPED/ DEVELOPING COUNTRIES

Notwithstanding differences in approaches to the question of underdevelopment, it is always possible to identify some common characteristics of underdeveloped/developing countries. Most underdeveloped countries, as already discussed, are poor and their present rate of capital formation is hardly adequate for sustained development efforts. Their economies are essentially agrarian and not much industrialisation has taken place in them, in response to demand for their products in export markets. In the following pages, we shall now discuss common characteristics of underdeveloped countries in some detail:

1. Low GNP per capita. GNP per capita in underdeveloped countries is appallingly low. Naturally, mass of the population leads a wretched life under subhuman conditions. In India, for example, where GNP per capita has been estimated to be $ 1,680 in 2016 at current prices, roughly one-third of the population is below the poverty line. On world scale, income inequalities between the developed and underdeveloped countries are not only large, but the gap between them increases with every year that passes. According to the World Bank estimates, in 2018, the average GNP per capita of the high income economies was $ 44,166, whereas it was $ 790 in low income underdeveloped countries. It is, however, pertinent to mention that all Third World countries are not equally underdeveloped in terms of GNP per capita. Brazil, Malaysia, Mexico, and Turkey are far more affluent than most of the South and East Asian countries such as India, Nepal, Pakistan, Bangladesh, Myanmar, and Indonesia. Depending upon the degree of underdevelopment, the development potentials in these countries differ significantly.

The estimates of GNP per capita are usually calculated by converting GNP to US dollars using exchange rates as conversion factors. These estimates, however, do not reflect appropriately the purchasing power of currencies due to the

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fact that relative prices of goods and services not traded on international markets vary substantially from one country to another. The use of purchasing power parity (PPP) conversion factors corrects for these differences and may, therefore, provide a better comparison of average income. If we use PPP estimates of GNP per capita, we find that income inequalities between the developed and underdeveloped countries are somewhat lower than those we observe on the basis of exchange rates as conversion factors. For instance, we can see from Table 1.1 that while GNP per capita in India was only $ 2,020 in 2018 as against $ 62,850 in USA, the PPP estimate of GNP per capita in India was $ 7,680 against $ 63,390 in USA in 2018. Thus, India's GNP per capita was less than *one-thirteenth* of USA's GNP per capita in 2018 but *one-eighth* of USA's PPP estimate of GNP per capita. Nevertheless, one cannot deny that there are substantial income inequalities as among the developed and the underdeveloped countries and within the underdeveloped countries themselves as brought out clearly in Table 1.1.

2. Scarcity of capital. The rate of capital formation is relatively low in most of the low income less developed economies due to widespread poverty. When the absolute income is high, the ability to save is also high. This explains why the rate of capital formation is high in Japan, a highly developed economy. In other developed countries, saving rates are modest because of the sway of consumerism. The saving rates are presently very high in some of the fast growing East Asian economies. For example, the saving rate in Malaysia, China and Singapore was 40 per cent or more than 40 per cent of GDP, on an average, during 1997-2003.[20] In most of the low income underdeveloped economies, the saving rate continues to be very low (less than 20 per cent of GDP in many cases). ***It has been argued by Ragnar Nurkse that most of the underdeveloped countries have been caught in the vicious circle of poverty, and thus their capacity to save is very low. On the demand side, the small size of the market acts as a disincentive and the potential savers indulge in wasteful consumption which they might not do, if adequate investment opportunities are available.***

3. Rapid population growth and high dependency burden. Population has been increasing in underdeveloped countries at the rate of 2 per cent per annum or more over the past several decades. This demographic trend has been determined mainly by the fact that the medical facilities now available in these countries have effectively brought down the mortality rates among all sections of the society, whereas the birth rate continues to be high due to widespread poverty, ignorance and religious orthodoxy. ***Fast growing population in the Third World countries is both a cause and an effect of underdevelopment.***

Over the past seven decades, the population in African, South Asian and Latin American countries has increased at an alarming rate making any significant improvement in the living standards of the people rather difficult. Some of the agrarian economies in these regions have actually recorded some decline in the living standards of the multitude of population in recent periods. Though this trend is unfortunate, it is not at all surprising. In any country where population grows roughly at a rate of 2 per cent per annum, for a stable per capita income the GNP must also record an annual increase of 2 per cent. Assuming a capital-output ratio of 4.0:1, which according to available statistical evidence is fairly reliable, an average 2 per cent annual increase in GNP would require an investment rate of 8 per cent. Therefore,

Table 1.1

GNP Per Capita and PPP Estimates of GNP Per Capita in US Dollars (2018)
(Selected Regions/Countries)

Developed Regions	*GNP per capita*	*PPP estimates of GNP per capita*	*Underdeveloped/Developing regions*	*GNP per capita*	*PPP estimates of GNP per capita*
High Income Economies	**44,166**	**51,175**	**Low Income Economies**	**790**	**2,225**
USA	62,850	63,390	**Lower Middle Income**	**2,245**	**7,586**
Germany	47,450	55,800	**Upper Middle Income**	**8,859**	**18,745**
UK	42,390	45,660	Malaysia	10,460	30,600
France	41,070	46,900	China	9,470	18,140
Japan	41,340	45,000	Brazil	9,140	15,820
Italy	33,560	42,490	Thailand	6,610	18,160
Korea, Rep. of	30,600	40,450	Indonesia	3,840	12,650
Greece	19,540	29,600	India	2,020	7,680
			Bangladesh	1,750	4,560
			Pakistan	1,580	5,840
			Ethiopia	790	2,010

Note: Countries are arranged in order of GNP per capita.
Source: World Bank, *World Development Indicators*, 2018.

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any country which plans for an annual 8 per cent rise in GNP (or 6 per cent annual rise in its GNP per capita) will have to mobilise roughly 32 per cent of its GNP for investment purposes. This, under given socio-economic framework of underdeveloped countries, appears to be rather difficult.

4. Low levels of productivity. Productivity of labour in underdeveloped countries is generally low. It is both a cause and an effect of the low levels of living in these countries. ***According to Todaro, "low levels of living and low productivity are self-reinforcing social and economic phenomena in Third World countries, and, as such, are the principal manifestations of and contributors to their underdevelopment."***[21] Obviously, at low levels of productivity the national income will be small and thus, apart from a microscopic minority, rest of the people in the country will have an appallingly low living standard. Hence, for raising the living standards of the mass of the presently deprived people, productivity of labour must rise considerably.

Labour productivity depends on a number of factors, such as, availability of other inputs which are combined with labour in production process, health and skill of workers, motivation for work and institutional set-up. The two inputs, *viz.*, capital and managerial skill when combined with labour in the required quantity raise its productivity substantially. But in underdeveloped countries these inputs are in short supply. If these countries wish to raise the productivity of labour, they will have to augment the supplies of these strategic inputs. Moreover, there are clear linkages between poverty of the workers and their health and skill which determine their productivity levels. Therefore, tackling of poverty in underdeveloped countries is required not merely because it involves a human problem, but it is quite important from the point of view of growth as well.

5. Technological backwardness. In underdeveloped countries over a wide range of industrial activity, production techniques are backward. Often, lack of Research and Development (R&D) is blamed for the technological backwardness in these countries. In certain cases, weak communication system between the research institutes and the producers is believed to be the cause of sorry state of affairs in this regard. This, however, does not explain the whole situation. In most cases, it is not the ignorance which prevents producers from making use of most sophisticated technology requiring extensive supply of capital. Many underdeveloped countries willingly opt for labour-intensive technology and their choice, though often dictated by their relative poverty, is not altogether irrational under the given circumstances. In the absence of any social security against unemployment, workers' unions oppose introduction of labour displacing technology in industries. This organised attempt of workers is certainly a retrogressive act from the point of view of economic growth, but in order to check an increase in unemployment, the State in underdeveloped countries cannot permit unrestricted replacement of outmoded machines by the most sophisticated ones.

6. High levels of unemployment and underemployment. Widespread unemployment particularly among the unskilled workers is an universal phenomenon in the Third World. Bulk of rural as well as urban unemployment in underdeveloped countries is involuntary. Due to high levels of poverty in these countries, markets for industrial products are small and provide little incentive to industrialists to expand their activities. Faced with lack of effective demand, industries grow haltingly and offer too few new job opportunities to the continuously increasing number of working population. The traditional agriculture characterised by low productivity also suffers from lack of labour absorption capacity. Hence, with an increasing pressure of population on land, disguised unemployment continues to grow. Peasants are often aware of this phenomenon, but in the absence of alternative employment opportunities, they stick to small pieces of land which are not adequate even for subsistence living. Over a period of time, structural unemployment in underdeveloped countries tends to grow worse. This is due to the absence of any automatic mechanism that could be called into play as unemployment rose. At present, the gravity of the situation can be followed from the fact that ***"almost 35 per cent of the combined urban and rural labour forces in poor nations is unutilised."***[22]

7. Lower level of human well-being. Generally, three broad kinds of indices are used in constructing a measure of a person's well-being: his current and prospective real income, his health and educational attainments. We have earlier stated in this chapter that in less developed countries, the GNP per capita is much lower than in developed countries. When we consider the two other indices, we find that the human well-being in less developed countries is far lower than that in developed countries. Let us now consider the health indicator first. ***In most studies, experts have relied on mortality indices and morbidity to judge the state of health. On these indicators, less developed countries are far behind the developed countries of the West.*** In 2017, life expectancy at birth for males was 61 years and for females 65.0 years in low income economies (as against this, life expectancy at birth for males was 78 years and for females 83.0 years in high income economies). Further, under five mortality rate in the low income economies was 69 per 1,000 live births in contrast to 5 in the high income economies in 2017. Quantitative measurement of morbidity is not easy. Yet, there is no doubt about the fact that the

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degree of morbidity is significantly higher in underdeveloped countries than in the developed countries.

The output of education is a durable good and thus its contribution to human well-being is significant. Further, among different levels of education it is the primary level that has the highest productive value (a rate of return of about 26 per cent). However, ***less developed countries have consistently underinvested in primary education relatively to education's higher reaches.***[23] As a consequence of this neglect of primary education, adult illiteracy rate in low income countries over the period 2005-14 was as high as 34 per cent for males and 52 per cent for females whereas it was almost nil in high income countries.

8. Wide income inequalities. Compared to developed countries, income inequalities are larger in underdeveloped countries. Data published in the *World Development Indicators, 2017* suggest that income disparities are far greater in many less developed countries than in the developed countries. For example, if we compare the share of national income accruing to the poorest 10 per cent of a country's population with that of the richest 10 per cent as a rough measure of income inequalities, we note that a great number of underdeveloped countries, *e.g.*, Kenya, Namibia, Lesotho, Nigeria, Zambia, Colombia, Malaysia, Brazil, Mexico and Argentina have considerable degree of income inequality, while developed industrial market economies such as Finland, Denmark, Netherlands, Sweden, Germany, France and Japan have relatively less inequalities. (See Table 1.2 for data on income inequalities for some developed and developing countries).

World Development Report 2006 asserts that "From an equity perspective, the estimation of opportunities matters more than the distribution of outcomes."[24] Unequal opportunities are large within many underdeveloped countries. Inequalities in health and education in these countries often translate into unequal economic opportunities.

9. High incidence of poverty. The extent of absolute poverty is an important dimension of the problem of income distribution in the developing countries. At relatively lower levels of GNP per capita, large income inequalities, as they exist in the developing countries of Asia, Africa and Latin America, have resulted in widespread poverty. The poverty problem could perhaps be overcome in these countries with a more equitable income distribution. In near future, if developing countries wish to wipe out poverty they have no choice except to improve the income distribution so as to ensure a minimum standard of living in terms of calorie intake and nutrition levels, clothing, sanitation, health, education and so on.

Poverty is, however, not easy to define and whatever be the approach, there is bound to be an element of arbitrariness in it. The World Bank now uses a poverty line of $ 1.90 (2011 purchasing power parity $) a day a person to compare poverty levels. According to this international poverty line, 44.6 per cent of the people were below the poverty line in South Asia in 1990 and 15.1 per cent in 2013. In Sub-Saharan Africa, 54.3 per cent of the people were below the poverty line in 1990 and 41.0 per cent in 2013. The number of poor people in South Asia was 256 million in 2013 while the number of poor people in

Table 1.2

Income Inequality in Selected Countries

Country	*Survey Year*	*Share of income or expenditure*		*Inequality measures*	
		Poorest 10%	*Richest 10%*	*Richest 10% to Poorest 10%*	*Gini index**
Developed Countries					
Denmark	2015	3.7	23.8	6.4	28.2
France	2015	3.1	26.6	8.6	32.7
Germany	2015	3.1	24.8	8.0	31.7
Netherlands	2015	3.5	23.0	6.6	28.2
Norway	2015	3.5	22.3	6.4	27.5
Sweden	2015	3.10	22.9	7.0	29.2
Underdeveloped Countries					
Brazil	2017	1.0	41.9	41.9	53.3
Colombia	2017	1.4	39.0	27.8	49.7
India	2011	3.5	30.1	8.6	35.7
Malaysia	2015	2.3	31.3	13.6	41.0
Mexico	2016	2.2	34.8	15.8	43.4
Nigeria	2009	2.0	32.7	16.4	43.0
Zambia	2015	1.0	44.4	44.4	57.1

* The Gini index lies between 0 and 100. A value of 0 represents absolute equality and 100 absolute inequality.

Source: World Bank, *World Development Indicators* 2018 (Washington DC, 2018), Table 1.3.

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Sub-Saharan Africa was 389 million in that year.[25] Levels of poverty in other underdeveloped regions of the world are also at comparable levels. Moreover, as pointed out by *Human Development Report* 2014, sizeable portions of the population of the developing countries are close to the poverty threshold (the 'near poor') and any 'shocks' could easily push a large number of people back into poverty.[26] Also, in addition to the fact of low levels of income on which the vast mass of the population has to subsist in the developing countries, there is ample evidence of malnutrition, disease, ill-health and illiteracy in less developed countries.

10. Agrarian economy. According to Harvey Leibenstein, underdeveloped economies are essentially agrarian in their character.[27] About 30 to 75 per cent of the population depends on agriculture in these countries. Therefore, it is quite natural that a significant part of the GDP originates in this sector (See Table 1.3). The share of income in agriculture is, however, less than the share of employment in agriculture which clearly reflects the relatively low productivity per labour unit in the agricultural sector. Moreover, as J.K. Galbraith has stated, ***"a purely agricultural country is likely to be unprogressive even in its agriculture".*** In spite of transfer of agricultural technology from developed countries to less developed countries, the situation has not significantly changed and Galbraith's observations remain as much correct now, as they were a few decades ago.

In underdeveloped countries, technologically agriculture is far more backward than in developed countries. Application of chemical fertilisers to soil is rather small and high-yielding variety (HYV) seeds have not been developed for all crops. In all those countries where per capita cultivable land is small due to high pressure of population, operational holdings are both subdivided and fragmented. Survival of feudal relations of production in agriculture has made the situation worse, as it has arrested development of agriculture on modern lines.

11. Lower participation in foreign trade. Some economists have asserted that most underdeveloped economies have foreign trade orientation. But this does not necessarily suggest that their proportions of exports and imports to domestic product are much higher than those of developed countries. According to Simon Kuznets, the extent of participation of a country in foreign trade cannot be measured directly because the proportion of foreign trade to total output is affected by the size of a country. He is therefore of the view that the effects of size should first be quantified and eliminated. "Once this adjustment is made, it becomes clear that ***the extent of participation in foreign trade by underdeveloped countries is distinctly lower than that of developed countries.***"[28] Underdevelopment of a country cannot, by itself, induce large foreign trade. The inadequate development of infrastructure for foreign trade, particularly transportation system, trade organisation and banks with overseas branches prevent growth of foreign trade. In addition, backwardness of production technology in underdeveloped countries is one such factor that would make large exports and imports impossible.

12. Dependence. Since the process of underdevelopment began in Asia, Africa and Latin America with their colonial exploitation by the metropolitan countries, and their economies over time got conditioned by the development in advanced capitalist countries, even though these countries have won political freedom, their dependence persists on their former rulers. This phenomenon has been caused by the integration of the economy of the colony with that of the metropolitan country giving rise to an international

Table 1.3

Employment and Income in Agriculture in Some Selected Developing Countries

Country	*Agricultural Employment as Percentage of Total Employment*	*Percentage of GDP Originating in Agriculture, value added (% of GDP)*
	2018	*2017*
(1)	*(2)*	*(3)*
Bhutan	57.0	17.4 (2017)
Ethiopia	66.0	31.1 (2018)
Ghana	34.0	19.7 (2017)
Guinea	67.0	17.8 (2018)
India	44.0	14.5 (2018)
Malawi	72.0	26.1 (2017)
Nepal	70.0	25.0 (2018)
Pakistan	42.0	22.6 (2018)
Sudan	43.0	31.5 (2018)
Uganda	71.0	24.2 (2018)
Vietnam	40.0	14.6 (2018)

Source: World Bank, *World Development Indicators, 2018.*

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division of labour which allows industrial development to take place only in the latter. The economies of colonies in the process became subservient to metropolitan interests and were forced to specialise in primary producing activities. The pattern and direction of their foreign trade is also conditioned by this basic development taking place in their structure. While most of the economy remains backward, a few industries are sometimes established in response to demand in foreign markets.[29] This explains why for a long period tea and jute contributed a major part of India's exports. Similarly, Brazil's great dependence on the exports of coffee, Malaysia's on rubber and Cuba's on sugar reflected the backward nature of their economies.

Apart from the above-mentioned characteristics of underdeveloped economies, there are a few other distinguishing features of these economies. For example, social life in the Third World countries is traditional. People are generally orthodox in their outlook and hardly make any attempt to change outdated socio-economic relations. ***The economic organisation thus remains retrogressive and proves to be a serious obstacle to development.*** Even though land reforms have been carried out in some underdeveloped countries, their rural structure continues to remain medieval. In some of these countries, special institutions of agricultural finance have not been set up and thus the grip of moneylenders on agriculture is quite strong.

As compared to developed countries, the human capital is also far less developed in the Third World countries. Whereas the adult literacy rate is as high as 99 per cent in high income countries, it is as low as 62 per cent in low income countries. Furthermore, the expenditure on research is pitiably low in underdeveloped countries.

Lastly, ***almost all underdeveloped countries are 'soft States'.*** Their characterisation as soft States implies that they lack social discipline. The legal system is also defective and various legislative measures are generally scuttled at implementation level. This happens because the bureaucracy operates under the influence of those very people whose

Box 1.2

Underdeveloped/Developing Countries: Common Characteristics

- **Low GNP per capita** — According to World Bank, low income economies and middle income economies are underdeveloped/ developing economies.
  - — GNP per capita in low income economies (2018) $ 790
  - — GNP per capita in lower middle income economies (2018) $ 2,245
  - — GNP per capita in India (2018) at market exchange rates $ 2,020
  - — GNP per capita in India (2018) in PPP terms $ 7,680
- **Scarcity of capital** — Most underdeveloped countries save less than 20 per cent of their GDP and they have smaller stock of capital.
- **Rapid population growth** — 2 per cent per annum or more.
- **Low levels of productivity** — Low levels of productivity and low levels of living reinforce each other.
- **Technological backwardness**
  - — Lack of R&D
  - — Labour displacing technology is opposed by the workers.
- **Unemployment and underemployment**
  - — Almost 30 per cent of labour remains unutilised or underutilised
  - — Disguised unemployment in agriculture is widespread.
- **Lower level of human well-being in low income economies**
  - — Adult illiteracy rate (2005-14): 34 per cent for males and 52 per cent for females
  - — Life expectancy at birth (2017): 61 years for males and 65 years for females
  - — Under five mortality rate (2017): 69 per thousand.
- **High incidence of poverty** — 256 million people in South Asia below the poverty line in 2013 (15.1 per cent of total population).
- **Agrarian economy** — 30-70 per cent of the workforce employed in agriculture.
- **Lower participation in foreign trade**
- **Dependence**
- **Less development of human capital**
- **Developing economies are 'Soft States'.**

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activities are to be regulated by the State. In Gunnar Myrdal's opinion, this acts as a serious obstacle to development in the Third World countries.

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2 Chapter

ECONOMIC AND HUMAN DEVELOPMENT

Economic development is a complex process. It is influenced by natural resources and both economic and non-economic factors. Role of natural resources has always been recognised in economic development. As a matter of fact, natural resources often decide the limits of development. Among the economic factors which determine the development process in any country, the most prominent ones are the available capital stock and the rate of its accumulation, capital-output ratio in various sectors, agricultural surplus, conditions in foreign trade and economic system. In addition, some non-economic factors such as size and quality of human resources, political freedom, social organisation, technical know-how and general education, absence of corruption and above all, will to develop on the part of the people play an important role in determining the pace and direction of development. It is also important to note at this juncture that the ultimate objective of all efforts is human development.

We shall focus on the following issues in this chapter:

- Role of natural resources in economic development
- Economic and non-economic factors which influence the development process in a country
- The concept of human development
- Human development – its rationale and components
- The human development index
- Gender inequality index
- Multidimensional poverty index
- Links between economic growth and human development index
- Recasting planning in terms of human development.

ROLE OF NATURAL RESOURCES IN ECONOMIC DEVELOPMENT

Until the 1930s, development or underdevelopment of an economy was often explained in terms of the relative quantities of natural resources available. Jacob Viner, William J. Baumol and W.A. Lewis are some of the leading economists who attached great importance to natural endowments of a country for its development. Jacob Viner has stated, "Much obviously depends on the character of the physical environment, or the 'quality', in my terminology, of the natural resources considered as factors of production.....An unfavourable physical environment can be a major obstacle to development."[1] Indeed, development and prosperity of a number of countries may be associated, among other things, with the kind and size of the resource base they have. Availability of fertile soil with abundant supply of water for irrigation purposes provides favourable conditions for agricultural development. Similarly, adequate reserves of coal and petroleum and water resources for electricity generation can be profitably utilised by an underdeveloped country for its transformation into a developed economy. Minerals like iron ore, copper, tin, bauxite, and uranium, if available in plenty, can induce the process of industrialisation. Sea coast provides navigation facilities necessary for overseas trade. As it has happened in Japan and Scandinavian countries, coast can prove to be a source of abundant supply of fish. Without these resources, there is not much hope for economic development. ***The natural endowments of a country place general limits on the possibilities of economic development. However, resource availability is not a sufficient condition for human progress.*** A number of countries in Latin America, Africa and Asia are favourably endowed with natural resources, yet their achievements in terms of economic progress are rather disappointing. Many parts of the world which are presently underdeveloped, are poor in terms of natural resources. Cases of Afghanistan and Tibet are often cited to prove that lack of natural resources can turn out to be a major obstacle to development. But this point is not to be stretched too far, as man often succeeds in overcoming the problems arising from the scarcity of natural resources. Switzerland, for example, has scarcely a single physical advantage for development, yet in wealth per capita it ranks as high as Germany, Britain and the USA which are rich in their physical endowments.

Furthermore, the relative role of natural resources in economic development of a country tends to decline as an economy grows. Theodore Schultz has pointed out that the ratio of the natural resources to the complex of all resources used in poor countries is about 20 to 25 per cent as against 5 per cent or even less in developed industrial countries.[2]

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ROLE OF ECONOMIC FACTORS IN ECONOMIC DEVELOPMENT

In a country's economic development, the role of economic factors is decisive. The stock of capital and the rate of capital accumulation in most cases settle the question whether at a given point of time a country will grow or not. There are a few other economic factors which also have some bearing on development but their importance is hardly comparable to that of capital formation. The surplus of foodgrains' output available to support urban population, foreign trade conditions and the nature of economic system are some such factors whose role in economic development has to be analysed.

1. Capital formation. The strategic role of capital in raising the level of production has traditionally been acknowledged in economics. With the development of growth economics in the post-World War II period, its role in economic progress has been increasingly emphasised. In fact, the Harrod-Domar model of growth has treated capital as the crucial factor in economic growth. It is now universally admitted that a country which wants to accelerate the pace of growth, has no choice but to save a high ratio of its income, with the objective of raising the level of investment. Great reliance on foreign aid is highly risky and thus has to be avoided. Economists rightly assert that ***lack of capital is the principal obstacle to growth and no developmental plan will succeed unless adequate supply of capital is forthcoming.***

Whatever be the economic system, a country cannot hope to achieve economic progress unless a certain minimum rate of capital accumulation is realised. However, if some country wishes to make spectacular strides, it will have to raise its rate of capital formation still higher. Japan had done precisely this in the late years of the 1970s. It had stepped up its saving rate to 37 per cent of the Gross Domestic Product. Until recently, in some other countries such as South Korea, Thailand, Malaysia, Hong Kong, and Singapore, saving rates were as high as 33 per cent or more. The high rate of capital formation in all these countries provides an explanation of their high rates of growth in recent years. In contrast, the rate of capital formation in India in the 1970s had fluctuated around 15 per cent of the GDP and only recently has risen to over 30 per cent.

Ragnar Nurkse has elaborately discussed the problem of capital formation in underdeveloped countries. ***He has argued that on the demand side there is a problem of small size of the market which fails to provide inducement to big scale investment activity. On the supply side, low level of per capita income and the demonstration effect in respect of consumption do not permit much improvement in the level of saving.*** Hence, the task of stepping up the rate of capital formation in the less developed countries is a really difficult one.

2. Marketable surplus of agriculture. Increase in agricultural production accompanied by a rise in productivity is important from the point of view of the development of a country. But what is more important is that the marketable surplus of agriculture increases. The term 'marketable surplus' refers to the excess of output in the agricultural sector over and above what is required to allow the rural population to subsist. The importance of the marketable surplus in a developing economy emanates from the fact that the urban industrial population subsists on it. With the development of an economy, the ratio of the urban population increases and increasing demands are made on agriculture for

Box 2.1

Factors in Economic Development

- **Natural Resources**
- **Economic Factors**
  - Capital formation
  - Marketable surplus of agriculture
  - Conditions in foreign trade
  - Economic system
- **Non-economic Factors**
  - Human resources
  - Technical know-how and general education
  - Political freedom
  - Social organisation
  - Corruption
  - Desire to develop

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foodgrains. These demands must be met adequately, otherwise the consequent scarcity of food in urban areas will arrest growth.

In case a country fails to produce a sufficient marketable surplus, it will be left with no choice except to import foodgrains which may cause a balance of payments problem. Until 1976-77, India was faced with precisely this problem. In most of the years during the earlier planning period, market arrivals of foodgrains were not adequate to support the urban population. In order to avert food crisis in cities, the government imported foodgrains in large quantities. This indeed solved the food problem, at the same time, it involved large-scale spending of foreign exchange which if used for other purposes, would have contributed more to the economic development of the country. Hence, ***if some country wants to step up the tempo of industrialisation, it must not allow its agriculture to lag behind. The supply of the farm products particularly foodgrains, must increase, as the setting up of industries in cities attracts a steady flow of population from the countryside.***

3. Conditions in foreign trade. The classical theory of trade has been used by economists for a long time to argue that trade between nations is always beneficial to them. In the existing context, the theory suggests that the presently less developed countries should specialise in production of primary products as they have comparative cost advantage in their production. The developed countries, on the contrary, have a comparative cost advantage in manufactures including machines and equipment and should accordingly specialise in them. In the past, List and some other protectionists had, however, argued that free trade based on this kind of specialisation was not beneficial to a developing economy. In the recent years, a powerful school has emerged under the leadership of Raul Prebisch which questions the merits of unrestricted trade between developed and underdeveloped countries on both theoretical and empirical grounds.

Unlike neo-classical economists, Prebisch looks at the relation between trade and development from the standpoint of balance of payments rather than real resources. He asserts that ***leaving aside some exceptional cases, unrestricted trade results in deficits in the balance of payments of developing countries. In addition, their terms of trade also deteriorate vis-a-vis developed countries. These disadvantages of free trade generally far outweigh any advantage with respect to a more efficient allocation of resources.***[3] Foreign trade has proved to be beneficial to countries which have been able to set up industries in a relatively short period. These countries sooner or later captured international markets for their industrial products. Therefore, a developing country should not only try to become self-reliant in capital equipment as well as other industrial products as early as possible, but it should also attempt to push the development of its industries to such a high level that in course of time manufactured goods replace the primary products as the country's principal exports.

4. Economic system. The economic system and the historical setting of a country also decide the development prospects to a great extent. There was a time when a country could have a *laissez-faire* economy and yet face no difficulty in making economic progress. England's economy was precisely the one in which there was minimal government intervention, and yet it steadily developed over a long period. In today's entirely different world situation, a country would find it difficult to grow along the England's path of development. In fact, ***The Third World countries of the present times will have to find their own path of development. They cannot hope to make much progress by adopting a laissez-faire economy.*** Further, these countries cannot raise necessary resources required for development either through colonial exploitation or by foreign trade. They now have only two choices before them. First, they can follow a capitalist path of development which will require an efficient market system supported by a rational interventionist role of the State. The other course open to them is that of economic planning. The latest experiments in economic planning in China have shown impressive results. Therefore, from the failure of economic planning in the former Soviet Union and the erstwhile East European socialist countries it would be wrong to conclude that a planned economy has built-in inefficiencies which are bound to arrest economic growth.

NON-ECONOMIC FACTORS IN ECONOMIC DEVELOPMENT

From the available historical evidence, it is now obvious that non-economic factors are as much important in development as economic factors. In the following pages, we attempt to explain how they exercise influence on the process of economic development.

1. Human resources. Human resources are an important factor in economic development. Economists often see population as an obstacle to growth rather than as a factor which will assist the developmental activity. Nevertheless, man makes positive contribution to growth. Man provides labour power for production and if in a country labour is efficient and skilled, its capacity to contribute to growth will decidedly be high. The productivity of illiterate, unskilled, disease ridden and superstitious people is generally low and they do not provide any hope to developmental work in a country. While discussing the

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causes of underdevelopment earlier, we have stated that ***if a country can manage to use its manpower properly, it will prove to be an important factor in development. But in case human resources remain either unutilised or the manpower management remains defective, the same people who could have made a positive contribution to growth activity prove to be a burden on the economy.*** It is this reason why a situation characterised as that of overpopulation in an underdeveloped country is seen as a growth arresting factor.

2. Technical know-how and general education. It has never been doubted that the level of technical know-how has a direct bearing on the pace of development. As the scientific and technological knowledge advances, man discovers more and more sophisticated techniques of production which steadily raise the productivity levels. Schumpeter was deeply impressed by the innovations done by the entrepreneurs, and he attributed much of the capitalist development to this role of the entrepreneurial class. Since technology has now become highly sophisticated, still greater attention has to be given to Research and Development for further advancement. If a country in modern times neglects this activity, it will have to pay a heavy price in terms of industrial underdevelopment. ***Under assumptions of a linear homogeneous production function and a neutral technical change which does not affect the rate of substitution between capital and labour, Robert M. Solow has observed that the contribution of education to the increase in output per man hour in the United States between 1909 and 1949 was more than that of any other factor.[4] T.W. Schultz,[5] A.K. Sen[6] and some others in the recent years have emphasised the contribution of investment in man for economic development.*** They all, however, find its quantitative measurement rather difficult. And, in fact, whatever results have been so far obtained in this regard are at best tentative.

3. Political freedom. Looking to the world history of modern times, one learns that the processes of development and underdevelopment are interlinked and it is wrong to view them in isolation. We all know that the underdevelopment of India, Pakistan, Bangladesh, Sri Lanka, Malaysia, Kenya and a few other countries, which were in the past British colonies, was linked with the development of England. England recklessly exploited them and appropriated a large portion of their economic surplus. This made a significant contribution to Britain's economic development. The colonies, however, were forced to remain backward in the process. Similarly, France's development was linked with the underdevelopment of Algeria and Indo-China, the Netherlands' development with the underdevelopment of Indonesia and the USA's development with the underdevelopment of Latin American countries. In fact, one cannot be correctly understood if viewed separately from the other.

Andre Gunder Frank has marshalled unquestionable evidence in support of his contention that the underdevelopment of Brazil and Chile cannot be explained in any other way except in terms of the US exploitation of these countries.[7] ***Dadabhai Naoroji has also candidly explained in his classic work 'Poverty and Un-British Rule in India' that the drain of wealth from India under the British was the major cause of the increase in poverty in India during that period, which in turn arrested the economic development of the country.*** Bipan Chandra's work lends powerful support to Naoroji's views on the country's underdevelopment during the British period. Bipan Chandra has noted that whatever little industrial development took place in India under the British was particularly in periods when India's economic relations with England were weak either due to war or some such other reason.[8] In a nutshell, we do not find any example of economic development under the colonial rule from history. Hence, political freedom is an essential condition for the economic development of a country.

4. Social organisation. Mass participation in development programmes is a precondition for accelerating the growth process. However, people show interest in the development activity only when they feel that the fruits of growth will be fairly distributed. Experiences from a number of countries suggest that whenever the defective social organisation allows some elite groups to appropriate the benefits of growth, the general mass of people develop apathy towards State's development programmes. Under the circumstances, it is futile to hope that masses will participate in the development projects undertaken by the State.

India's experience during the whole period of development planning is a case in point. Growth of monopolies in industries and concentration of economic power in the modern sector is now an undisputed fact. Furthermore, the new agricultural strategy has given rise to a class of rich peasantry creating widespread disparities in the countryside. Most people think that these facts are sufficient to prove that India's social organisation is anything but just. Hence, it is not at all surprising that there is widespread apathy towards development planning in this country.

5. Corruption. Corruption is rampant in developing countries at various levels and it operates as a negative factor in their growth process. Until and unless these countries root out corruption in their administrative system, it is most natural that the capitalists, traders and other powerful economic classes will continue to exploit national

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resources in their personal interests. Furthermore, a substantial portion of the outlay on development projects is appropriated by the government officials and other functionaries by employing corrupt means. The regulatory system is also often misused and the licences are not always granted on merit. The art of tax evasion has been perfected in the less developed countries by certain sections of the society and often taxes are evaded with the connivance of the government officials. Under conditions of rampant corruption, it is futile to hope that the pace of development will be fast.

6. Desire to develop. ***Development activity is not a mechanical process. The pace of economic growth in any country depends to a great extent on people's desire to develop.*** If in some country level of consciousness is low and the general mass of people has accepted poverty as its fate, then there will be little hope for development. Richard T. Gill has candidly remarked, "The point is that economic development is not a mechanical process; it is not a simple adding up of assorted factors. Ultimately, it is a human enterprise. And like all human enterprises, its outcome will depend finally on the skill, quality and attitudes of the men who undertake."[9]

HUMAN DEVELOPMENT

In recent years, ***the search for an alternative to GNP as a measure of economic development has led to computation of the Human Development Index (HDI).*** The United Nations Development Programme (UNDP) introduced the HDI in its first *Human Development Report* prepared under the able stewardship of Mahbub ul Haq, and published in 1990. The measure has been enlarged and refined over the years and many related indices of human development like Gender-related Development Index (GDI), Gender Empowerment Measure (GEM), Gender Inequality Index (GII), Human Poverty Index (HPI) and Multidimensional Poverty Index (MPI) have been developed in subsequent *Human Development Reports* published annually by the UNDP.

What is Human Development?

Since its launch in 1990, the *Human Development Report* has defined human development as the process of enlarging people's choices. The most critical ones are to lead a long and healthy life, to be educated and to enjoy a decent standard of living. Additional choices include political freedom, other guaranteed human rights and various ingredients of self-respect. These are among the essential choices, the absence of which can block many other opportunities. ***Human development is thus a process of widening people's choices as well as raising the level of well-being achieved.***[10] Thus, as noted by Paul Streeten, the concept of human development puts people back at centre stage, after decades in which a maze of technical concepts had obscured this fundamental vision.[11]

According to Mahbub ul Haq, ***"the defining difference between the economic growth and the human development schools is that the first focuses exclusively on the expansion of only one choice — income — while the second embraces the enlargement of all human choices — whether economic, social, cultural or political."***[12] It is sometimes suggested that the expansion of income can enlarge all other choices as well. This may happen but generally, does not, on account of a variety of reasons. *First,* income may be unevenly distributed within a society. The choices of those people who have either no access to income or a very limited access, are very much limited. Thus, economic growth does not 'trickle down'. *Second,* and more importantly, the national priorities chosen by the society or its rulers and the political structure prevalent in the society may not allow the income expansion to enlarge human options. As emphasised by Mahbub ul Haq, 'use of income' by a society is just as important as 'generation of income' itself as would be clear from the fact that income expansion leads to much less human satisfaction in a virtual political prison or cultural void, than in a more liberal political and economic environment. Accumulation of wealth may not be necessary for the fulfilment of several kinds of human choices. In fact, many choices do not require any wealth at all. For instance, "a society does not have to be rich to afford democracy. A family does not have to be wealthy to respect the rights of each member. A nation does not have to be affluent to treat women and men equally. Valuable social and cultural traditions can be and are maintained at all levels of income."[13]

There are many human choices that extend far beyond economic well-being. Knowledge, health, a clean physical environment, political freedom and simple pleasures of life are not dependent on income. Accumulation of wealth can expand people's choices in these areas but this is not necessary. It is the *use of wealth* and not *wealth itself* that is decisive. Haq thus rightly warns, ***"unless societies recognise that their real wealth is their people, an excessive obsession with creating material wealth can obscure the goal of enriching human life."***[14]

WHY HUMAN DEVELOPMENT?

According to Paul Streeten, human development is necessary on account of the following reasons:[15]

1. Human development is the *end* while economic growth is only a *means* to this end. The ultimate purpose

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Box 2.2

Human Development

- **Human Development is a widening of people's choices as well as an improvement in the levels of well-being achieved.**
- **Human Development is necessary on account of the following reasons:**
  - Human Development is the end, while economic growth is a means to this end.
  - It is a means to higher productivity.
  - It helps in lowering the family size.
  - It creates good physical environment.
  - It contributes to a healthy civil society.
- **Essential components of Human Development are:**
  - Equity
  - Sustainability
  - Productivity
  - Empowerment.

of the entire exercise of development is to treat men, women and children — present and future generations — as ends, to improve the human condition, to enlarge people's choices.

2. Human development is a means to higher productivity. A well-nourished, healthy, educated, skilled, alert labour force is the most important productive asset. Thus, investments in nutrition, health services and education are justified on grounds of productivity.

3. It helps in lowering the family size by slowing human reproduction. It is the experience of all developed countries that improvement in education levels (particularly of girls), better health facilities and reduction in infant mortality rates leads to a lowering of the birth rates. While improved education facilities make people aware of the benefits of a small family (a higher income level, better standard of living, etc.), reduction in infant mortality rates reduces the incentive of having large families as fewer child deaths are now feared.

4. Human development is good for physical environment. Deforestation, desertification and soil erosion decline when poverty declines. How population growth and population density affect the environment is a subject of controversy. The conventional view is that they have a detrimental effect. However, Paul Streeten cites recent research to show that rapid (though not accelerating) population growth and high population density (particularly if combined with secure land rights) can be good for soil and forest conservation.

5. Human development and reduced poverty contributes to a healthy civil society, increased democracy and greater social stability. Moreover, human development can help in reducing civil disturbances in a society and in increasing political stability.

The above discussion shows that ***human development paradigm embraces the entire society not just the economy. The political, cultural and social factors are given as much importance as the economic factors. What is more, a careful distinction is maintained between ends and means.*** While people are regarded as the end of development, the means are not forgotten. In this context, the expansion of GNP becomes an essential means for expanding many human options. However, the character and distribution of economic growth are measured in terms of enriching the lives of people. People do not just remain the instruments for producing commodities but acquire the centre stage. Production processes are not treated in an abstract vacuum but acquire a 'human' context.

ESSENTIAL COMPONENTS OF HUMAN DEVELOPMENT

According to Mahbub ul Haq, there are four essential components in the human development paradigm: equity, sustainability, productivity and empowerment.[16]

Equity. If development is to enlarge people's choices, ***people must enjoy equitable access to opportunities.*** Equity in access to opportunities demands a fundamental restructuring of power in many societies and changes along the following lines: (*i*) change in the distribution of productive assets especially through land reforms; (*ii*) major restructuring in the distribution of income through progressive fiscal policy, aimed at transferring income from the rich to the poor; (*iii*) overhauling of the credit systems so that the credit requirements of the poor people are satisfactorily met; (*iv*) equalisation of political opportunities through voting rights reforms, campaign finance reform, and other actions

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aimed at limiting the excessive political power of a feudal minority; and (*v*) undertaking steps to remove social and legal barriers that limit the access of women or of certain minorities or ethnic minorities to some of the key economic and political opportunities.

Sustainability. ***The next generation's right to enjoy the same well-being that we now enjoy makes sustainability an essential component of the human development paradigm.*** At times, the concept of sustainability is confused with the renewal of natural resources, which is just one aspect of sustainable development. As emphasised by Mahbub ul Haq, "it is the sustainability of human opportunities that must lie at the centre of our concerns". This, in turn, requires sustaining all forms of capital — physical, human, financial and environmental. Sustainability is a matter of distributional equity — of sharing development opportunities between present and future generations and ensuring intragenerational and intergenerational equity in access to opportunities. However, as cautioned by Haq, "Sustainability does not mean sustaining present levels of poverty and human deprivation. If the present is miserable and unacceptable to the majority of the world's people, it must be changed before it is sustained. In other words, ***what must be sustained are worthwhile life opportunities, not human deprivation.***"[17] Not only this, sustainability also means that wide disparities in lifestyles within and between nations must be re-examined and efforts undertaken to reduce them. This is due to the reason that an unjust world is inherently unsustainable — both politically and economically. It may be environmentally unsustainable as well.

Productivity. "An essential part of the human development paradigm is productivity, which requires investments in people and an enabling macroeconomic environment for them to achieve their maximum potential. Economic growth is, therefore, a subset of human development models — an essential part but not the entire structure." Many East Asian economies like Japan and the Republic of Korea have accelerated their growth through tremendous investments in human capital. In fact, most of the development literature has focused on the productivity of human endeavour. Many recent models of development are based primarily on human capital. However, as correctly pointed out by Haq, this approach treats people only as a means of development and obscures the centrality of people as the ultimate end of development. ***Therefore, it is better to treat productivity only as one part of the human development paradigm — with equal importance given to equity, sustainability and empowerment.***

Empowerment. ***Human development paradigm envisages full empowerment of the people. Empowerment means that people are in a position to exercise choices of their own free will.*** "It implies a political democracy in which people can influence decisions about their lives. It requires economic liberalism so that people are free from excessive economic controls and regulations. It means decentralisation of power so that real governance is brought to the doorstep of every person. It means that all members of civil society, particularly non-governmental organisations, participate fully in making and implementing decisions."[18] The empowerment of people requires action on various fronts: (*i*) it requires investing in the education and health of the people so that they can take advantage of market opportunities; (*ii*) it requires ensuring an enabling environment that gives everyone access to credit and productive assets so that the playing fields of life are more even; and (*iii*) it implies empowering both women and men so that they can compete on an equal footing.

THE HUMAN DEVELOPMENT INDEX

The above discussion shows that ***the concern of development economists in recent years has shifted from economic growth to human development.*** For too long, the recurrent question was, how much is a nation producing? Increasingly now the question that is being asked is, how are its people faring? The main reason for this shift in focus is the growing recognition that the real objective of development is to enlarge people's options. Income is only one of the options — and an extremely important one. But, it is not the sum total of human life. Education and literacy, health, physical environment, equality of opportunities to all people irrespective of sex, caste and creed, political freedom, etc., may be just as important as income.

However, while human development is indeed the 'end' of all activity, its measurement is not an easy task. While economic growth has traditionally been measured in terms of GNP or GNP per capita, it is difficult to decide how human development is to be measured particularly in view of its various dimensions as pointed out earlier. The search for a comprehensive measure that could capture the various dimensions of human development led to the definition and formulation of Human Development Index (HDI) by the United Nations Development Programme (UNDP) in its *Human Development Report* (hereafter *HDR*) published in 1990. It is of course agreed that the concept of human development is much wider and richer than what can be caught in any index or set of indicators. However, such indexes are useful in focusing attention and simplifying problems. They have considerable political appeal. They have a stronger impact on the mind and draw public attention more powerfully than a long list of indicators combined with a qualitative discussion. As noted by Streeten, the

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strongest argument in favour of such indexes is that they show up the inadequacies of other indexes, such as GNP. They redirect our attention from one set of items to others — in the case of the HDI, to the social sectors: nutrition, education and health.[19]

HDI does not replace GNP but adds considerably to an understanding of the real position of a society in many respects as would be clear from the following discussion: (1) Besides income, the HDI measures education and health and is thus multidimensional rather than one-dimensional; (2) It focuses the attention of the policymakers on the ultimate objective of development, not just the means; (3) It is more meaningful as a national average than GNP because there are much greater extremes in income distribution than in the distribution of life expectancy and literacy; (4) Any upward movement in HDI can be regarded as an improvement; (5) Whereas high incomes for some can cause relative deprivation for others, this is not true for human development. If anything, improving the health and education of anyone benefits the entire community; (6) It shows that human development gaps between nations are more manageable than the ever-widening disparities in income. Since 1960, average life expectancy has increased by 16 years, adult literacy by 40 per cent and nutritional levels by more than 40 per cent, and child mortality rates have been halved. The international gap in these indicators is closing while in the case of GNP per capita it is widening. While average income per head in the South is 6 per cent of that in the North, life expectancy is 80 per cent, literacy 60 per cent and nutrition 85 per cent; (7) The HDI can be disaggregated by gender, ethnic group or geographical region and in many other ways — to present relevant policy measures and the 'danger points' of explosion.

The principles that have guided the search for HDI are as follows:[20]

First, ***the new index would measure the basic concept of human development to enlarge people's choices.*** Those choices covered the desire to live long, to acquire knowledge, to have a comfortable standard of living, to be gainfully employed, to breathe clean air, to be free, to live in a community. Obviously, all these cannot be quantified or measured. The basic idea was to measure at least some more choices besides income and to reflect them in a methodologically sound composite index.

Second, to keep the index simple and manageable ***it was decided to include only a limited number of variables.*** For instance, *HDR* 2009 chose ***life expectancy at birth*** as ***an index of longevity, adult literacy rate (two-third weight) and combined primary, secondary and tertiary enrollment rates (one-third weight) as an index of knowledge, and GDP per capita (in US $) adjusted for Purchasing Power Parity as an index of access to a multiplicity of economic choices (in other words, a decent standard of living).*** *HDR* 2010 made important changes in these definitions (see next section).

Third, ***it was decided to construct a composite index rather than a plethora of indexes.*** However, this posed several problems. Unlike GDP, for which money serves as a "common measuring rod", there was no such common currency for measuring socio-economic progress. Life expectancy is measured in years, adult literacy in percentage of adults, and real income in PPP-adjusted dollars. The question was: How to reduce these indicators to a common denominator? To tackle this question, it was decided to measure the actual progress in each indicator as relative distance from a desirable goal. The maximum and minimum observed values for each variable were reduced to a scale between 0 and 1: each country was at some point on this scale. As far as the question of weightage is concerned, it was agreed to assign equal weights to the three variables on the simple premise that all these choices were very important and that there was no *a priori* rationale for giving a higher weight to one choice rather than to another.

Fourth, ***it was decided to cover both economic and social choices in HDI.*** A mistake in the past had been to construct separate measures for economic progress (GNP) and for social progress (such as the physical quality of life index, or PQLI). Such a formulation missed the synergy between social and economic progress. The truth of the matter is that economic growth increases the resources and options available for social progress, whereas social progress creates a conducive environment for economic growth. Thus, both move hand-in-hand. The real GDP per capita or GNP per capita (PPP dollars) is the economic indicator and the life expectancy and educational attainment the social indicators in HDI.

Construction of Human Development Index

As stated above, 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 and a decent standard of living. Since 2010, HDI is being defined in *HDR* as the ***geometric mean of normalised indices measuring achievements in each dimension*** (prior to *HDR* 2010, simple arithmetic mean of the three dimension indices used to be taken).

In *HDR* 2010, the ability to enjoy a long and healthy life is defined in terms of life expectancy at birth which is the same as in earlier *Reports.* However, changes in definition of the 'knowledge dimension' and 'standard of living dimension' have been carried out. In the earlier *Reports,*

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GDP per capita in PPP dollars was used as a measure of standard of living while in *HDR* 2010 it has been replaced by GNP per capita in PPP dollars. This is due to the reason that "in a globalised world, differences are often large between the income of a country's residents and its domestic production."[21] As far as the knowledge dimension is concerned, mean years of schooling replaces literacy, and gross enrollment is recast as expected years of schooling — the years of schooling that a child can expect to receive given current enrollment rates. According to *HDR* 2010, "mean years of schooling is estimated more frequently for more countries and can discriminate better among countries, while expected years of schooling is consistent with the reframing of this dimension in terms of years."[22]

Creating the Dimension Indices: The first step is to create sub-indices for each dimension. Minimum and maximum values *(goalposts)* need to be set in order to transform the indicators into indices between 0 and 1. The goalposts act as the 'natural zeros' and aspirational goals, respectively, from which component indicators are standardised. The goalposts taken in *HDR* are as given in Table 2.1.

The justification for placing the natural zero for life expectancy at 20 years is based on the historical evidence that no country in the 20th century had a life expectancy of less than 20 years.

Societies can subsist without formal education, justifying the education minimum of 0 years. The maximum for mean years of schooling, 15, is the projected maximum of this indicator for 2025. The maximum for expected years of schooling, 18, is equivalent to achieving a master's degree in most countries.

The low minimum value for gross national income (GNI) per capita, $ 100, is justified by the considerable amount of unmeasured subsistence and non-market production in economies close to the minimum, which is not captured in official data. The maximum is set at $ 75,000 per capita as Kahneman and Deaton (2010) have shown that there is virtually no gain in human development and well-being from annual income beyond $ 75,000.[23] Currently, only four countries (Kuwait, Liechtenstein, Qatar and Singapore) exceed the $ 75,000 income per capita ceiling.

Having defined the minimum and maximum values, the dimension indices are calculated as

$$\text{Dimension index} = \frac{\text{actual value} - \text{minimum value}}{\text{maximum value} - \text{minimum value}} \quad \ldots(1)$$

For the education dimension, equation (1) is first applied to each of the two indicators, and then the arithmetic mean of the two resulting indices is taken.

For calculating income index, log of income continues to be taken as before.

Calculating HDI from Dimension Indices: *HDR* 2014 defines HDI as the geometric mean of the three dimension indices:

$$\left(I_{\text{Life}}^{1/3} \cdot I_{\text{Education}}^{1/3} \cdot I_{\text{Income}}^{1/3}\right) \quad \ldots(2)$$

Prior to 2010, simple arithmetic mean of the dimension indices used to be taken. Some economists had criticised this methodology as linear aggregation formula implied perfect substitutability across dimensions. Use of geometric mean acknowledges the fact that there is imperfect substitutability among the three dimension indices. Moreover, as a basis for comparisons of achievement, this method is also more respectful of the intrinsic differences in the dimension than a simple average is.

HDI for India: In India, GNI (Gross National Income) per capita in 2017 was $ 6,353 (in terms of 2011 $ PPP), life expectancy at birth in 2015 was 68.8 years, mean years of schooling in 2017 were 6.4 years, and expected years of schooling in 2017 were 12.3 years.

Dimension indices are then obtained as follows:

$$\text{Health index} = \frac{68.8 - 20}{85 - 20} = 0.7508$$

$$\text{Mean years of schooling index} = \frac{6.4 - 0}{15 - 0} = 0.4267$$

$$\text{Expected years of schooling index} = \frac{12.3 - 0}{18 - 0} = 0.6833$$

Table 2.1

Goalposts for Calculating the HDI According to *HDR*

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

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$$\text{Education index} = \frac{0.4267 + 0.6833}{2} = 0.555$$

$$\text{Income index} = \frac{\log 6,353 - \log 100}{\log 75,000 - \log 100} = 0.6271$$

$$(0.7508 \times 0.555 \times 0.6271)^{1/2} = 0.640$$

Human Development Index =

$$(0.7508 \times 0.555 \times 0.6271)^{1/3} = 0.646$$

Latest data on HDI are available for the year 2018. According to this data, Norway with a HDI value of 0.953 in 2017 ranks first and Switzerland with a HDI value of 0.944 ranks second. India with a HDI value of 0.640 ranks a lowly 130th in terms of human development out of the 189 countries for which *Human Development Report* 2018 calculated the index. Niger Republic with a HDI value of 0.354 occupies the last place in HDI ranking.

Inequality-Adjusted HDI

HDR 2010 introduced three new measures — the Inequality-adjusted Human Development Index, the Gender Inequality Index and the Multidimensional Poverty Index. As far as IHDI (Inequality-adjusted Human Development Index) is concerned, it takes into account not only a country's average human development, as measured by health, education and income indicators, but also how it is distributed. Differentiating between HDI and IHDI, *HDR* 2010 states, "We can think of each individual in a society as having a 'personal HDI'. If everyone had the same life expectancy, schooling and income, and hence the average societal level of each variable, the HDI for each society would be the same as each personal HDI level and hence the HDI of the 'average person'. In practice, of course, there are differences across people, and the average HDI differs from the personal HDI levels. The IHDI accounts for inequalities in life expectancy, schooling and income, by 'discounting' each dimension's average value according to its level of inequality. ***The IHDI will be equal to the HDI when there is no inequality across people, but falls further below the HDI as inequality increases.*** In this sense, the HDI can be viewed as an index of 'potential' human development (or the maximum IHDI that could be achieved if there were no inequality), while the IHDI is the actual level of human development (accounting for inequality). ***The difference between the HDI and the IHDI measures the 'loss' in potential human development due to inequality."***[24]

HDR 2018 estimates the total loss in human development due to multidimensional inequalities, the loss in each dimension and the effects of inequality on country's HDI rank. The inequality-adjusted HDI value is 31 per cent lower than the HDI value in Sub-Saharan Africa and more than 25 per cent lower in South Asia and the Arab States. In two countries – the Central African Republic and Comoros – the Inequality-adjusted HDI value is more than 40 per cent lower. In 33 other countries, it is 30-40 per cent lower. As far as India is concerned, its average loss in HDI is 26.9 per cent (the IHDI for India being 0.468 as against HDI of 0.640) — its loss in HDI is 38.7 per cent in education and 21.4 per cent in life expectancy.[25]

GENDER INEQUALITY INDEX

Human Development Report 1995 launched two global gender indices — the Gender-related Development Index (GDI) and the Gender Empowerment Measure (GEM). ***The GDI attempted to capture achievements through the same set of basic capabilities as included in the HDI — life expectancy, educational attainment and income — but adjusted the HDI for gender inequality.*** The greater the gender disparity in basic human development, the lower was a country's GDI compared to HDI. ***The GEM indicated whether women are able to actively participate in economic and political life.*** It focused on political participation (measured by women's shares of parliamentary seats), economic participation (shares of high-level and professional positions), and power over economic resources (income gaps).

The following three drawbacks of GDI and GEM were pointed out by some critics:[26]

1. The measures combine absolute and relative achievements. Thus, a country with low absolute income scores poorly, even with perfect gender equity. The GDI adjusts the HDI for gender inequalities, thereby measuring both total achievements and disparities — though it is often misinterpreted as reflecting only the latter.

2. Extensive imputations were needed to fill in missing data. For the relative income shares in both indices, more than three-fourths of country estimates were partly imputed. With income the most important driver of the wedge between the HDI and the GDI, this imputation was particularly problematic.

3. Nearly all indicators in the GEM reflect a strong urban elite bias and use some indicators more relevant to developed countries.

HDR 2010 introduced a new measure Gender Inequality Index (GII) to address the above criticisms. GII does not rely on imputations. ***It includes three critical dimensions for women — reproductive health, empowerment and labour market participation.*** 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 as possible in all measured dimensions.

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Women experience many kinds of disadvantage and discrimination in health, education and employment. To highlight these disparities, *HDR* 2018 presents HDI values separately for women and men. ***Worldwide the female HDI value averages about 6 per cent lower than the male HDI value.*** Among regions, the largest gap is in South Asia (16.3 per cent). The gap is small (1.7 per cent) in the very high human development group but about 14 per cent in the low human development group. Finland has achieved gender parity, while female HDI values are slightly higher than male values in 18 countries.

The Gender Inequality Index reveals the extent to which national achievements in reproductive health, empowerment and labour market participation are eroded by gender inequality. Unlike the HDI, a higher GII value indicates poor performance. Values of GII in 2017 range from an average of 0.270 for Europe and Central Asia to 0.569 for Sub-Saharan Africa and from an average of 0.170 for the very high human development group to 0.586 for the low human development group. Switzerland outperforms all other countries (0.04), while Yemen has the highest value (0.834).[28] India with GII value of 0.521 in 2018 ranks 127th.

Poor reproductive health services are a major contributor to gender inequality, especially in developing countries. For example, the maternal mortality ratio is 549 deaths per 1,00,000 live births in Sub-Saharan Africa. Maternal deaths naturally have serious implications for babies and their older siblings left without maternal care, who could be trapped in low human development throughout their life cycle. Adolescent births could also lead to debilitating human development outcomes for young mothers and their babies. In Sub-Saharan Africa, there are 101.3 births per 1,000 women aged 15-19.

The deficits in education are wide as well. On average, 62.5 per cent of women aged 25 and older have at least some secondary education, compared with 70.9 per cent of men. This discrepancy is particularly large for the low human development group (18.5 per cent versus 30.7 per cent). And South Asia has the largest gender gap in education (only 40 per cent of women aged 25 and older have at least some secondary education as against 60.6 per cent of men). The very high human development group has near gender parity at this level (88.8 per cent versus 89.5 per cent).

Women also lag behind men in labour market participation (48.7 per cent compared with 75.3 per cent). The situation is less promising for women in the Arab States, where 20.1 per cent of women of working age participate in the labour market, compared with 74.2 per cent of men. Labour force participation rates tend to be higher among women in Sub-Saharan Africa because women are more often than not forced to eke a living in the informal sector.

MULTIDIMENSIONAL POVERTY INDEX

Human Development Report 1997 introduced the concept of a Human Poverty Index (HPI) to bring together in a composite index the different features of deprivation in the equality of life to arrive at an aggregate judgement on the extent of poverty in a community. It measured deprivation in basic human development in the same dimensions as the HDI. *HDR* 2009 used the following variables for calculating HPI: probability at birth of not surviving to age 40 (times 100); adult illiteracy rate; and unweighted average of population not using improved water sources and children underweight for age.

HPI used country averages to reflect aggregate deprivation in health, education and standard of living. It could not identify specific individuals, households or larger groups of people as jointly deprived. To tackle this problem, *HDR* 2010 introduced a new measure — Multidimensional Poverty Index (MPI) to replace HPI. The MPI is the product of the multidimensional poverty headcount (the share of people who are multidimensionally poor) and the average number of deprivations each multidimensionally poor household experiences (the intensity of their poverty). ***It has three dimensions mirroring the HDI — health, education and living standards — which are reflected in 10 indicators.*** The maximum score is 100 per cent, with each dimension equally weighted (thus the maximum score in each dimension is 33.3 per cent). The education and health dimensions have two indicators each, so each component is worth 5/3 (or 16.7 per cent). The standard of living dimension has six indicators, so each component is worth 5/9 (or 5.6 per cent).

HDR 2010 presented MPI estimates for 105 countries. It found that about a third of the population in these countries, or almost 1.75 billion people experienced multidimensional poverty. More than half lived in South Asia, though rates were highest in Sub-Saharan Africa, with significant variation across regions, groups and indigenous people. Eight Indian States, with poverty as acute as the poorest 26 African countries, were home to 421 million multidimensionally poor people.

HDR 2018 estimates MPI for 105 countries. It observes that about 1.33 billion people in these countries live in multidimensional poverty. Conditions in countries falling in medium human development category and low human development category are particularly bad. In most of these countries, more than one-third of the population suffers from multidimensional poverty. In fact, in countries falling in low human development category, more than half of the population suffers from multidimensional poverty. The worst

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Box 2.3

Measuring Human Development and Deprivations

- Human development index (HDI) is a summary measure of human development.
- HDI measures average achievements in a country in three basic dimensions of human development: a long and healthy life, access to knowledge and a decent standard of living.
- A long and healthy life is measured by life expectancy.
- *HDR* measures knowledge by mean years of schooling and expected years of schooling.
- *HDR* measures decent standard of living by GNP per capita (PPP US $).
- *HDR* 2018 has given HDI estimates for 189 countries. Norway and Switzerland with HDI value of 0.953 and 0.944 rank first and second respectively. India with a HDI value of 0.640 ranks a lowly 130th.
- IHDI (Inequality-adjusted Human Development Index) takes into account not only a country's average human development, as measured by health, education and income indicators, but also how it is distributed.
- The difference between the HDI and the IHDI measures the 'loss' in potential human development due to inequality. The average loss of India in HDI is 26.9 per cent (the IHDI for India being 0.468 as against HDI of 0.640).
- Gender Inequality Index (GII) includes three critical dimensions for women — reproductive health, empowerment and labour market participation. The index shows the loss in human development due to inequality between female and male achievements in these dimensions.
- Values of GII in 2017 range from an average of 0.270 for Europe and Central Asia to 0.569 for Sub-Saharan Africa and from an average of 0.170 for the very high human development group to 0.586 for the low human development group. India with a GII of 0.524 occupies a lowly 127th position.
- Multidimensional poverty index (MPI) is the product of the multidimensional poverty head count (the share of people who are multidimensionally poor) and the average number of deprivations each multidimensionally poor household experiences (the intensity of their poverty).
- MPI has three dimensions mirroring the HDI — the health, education and living standards.
- *HDR* 2018 presented MPI estimates for 105 countries. It found that almost 1.33 billion people in these countries experience multidimensional poverty. Conditions are particularly bad in countries falling in medium human development category and low human development category. In low human development countries, more than half of the population suffers from multidimensional poverty.
- According to *HDR* 2018, in India, 27.5 per cent of the population, *i.e.,* as many as 36.4 crore people suffered from multidimensional poverty in 2015-16.

condition is of Niger where 90.6 per cent of the population suffered from multidimensional poverty in 2012, intensity of deprivation is as high as 65.3 per cent and 74.9 per cent of the population lives in conditions of severe poverty. ***In India, 27.5 per cent of the population, suffered from multidimensional poverty in 2015-16***. Not only this, 8.6 per cent of the population lived under conditions of severe poverty in 2015-16. As far as the international poverty line of $ 1.90 per capita per day is concerned, 21.2 per cent of India's population was below this poverty line during the period 2006-16.[28]

LINKS BETWEEN ECONOMIC GROWTH AND HUMAN DEVELOPMENT

Emphasis on human development and the construction of Human Development Index and related indexes (like Gender-related Development Index, Gender Empowerment Measure and Human Poverty Index) has been the most important contribution of the development economists to economic literature in recent years. It has shifted the focus from the 'quantity of growth' to the 'structure and quality of growth'. We now realise that ***"success in economic growth must ultimately be judged by what it does to our lives — the quality of life we can enjoy and the liberties we can exercise. In general, economic growth cannot be dissociated from the 'end' of promoting human capabilities and of enhancing well-being and freedom.***[29] Governments are now becoming increasingly aware that unless they take corrective action, economic growth can become lopsided and flawed. ***'Lopsided and flawed' economic growth would mean economic growth that is jobless, ruthless, voiceless, rootless and futureless.'***[30] ***'Jobless growth'*** implies a situation where the overall economy grows but does not expand the opportunities for employment. ***'Ruthless growth'*** implies a situation where the fruits of economic growth mostly benefit the rich, leaving millions of people struggling in ever-deepening poverty. ***'Voiceless growth'*** implies a situation where people are ruled by repressive regimes and women are given only a minor role in an economy's management and direction. ***'Rootless growth'*** is a growth

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that causes people's cultural identity to wither. ***'Futureless growth'*** refers to rampant and uncontrolled economic growth — a growth where present generation squanders resources needed by future generations.

Avoiding the above pitfalls of growth requires fostering of strong links between economic growth and human development. This can be accomplished in the following ways:

1. ***Provision of remunerative employment to people*** as economic growth is translated into people's lives when they are offered productive and well-paid work. This would require the adoption of patterns of growth that are heavily labour-intensive.

2. ***More equitable distribution of income and economic opportunities*** as this is necessary for improving the general human well-being on the one hand, and for creating a close link between economic growth and human development on the other hand.

3. ***Access to productive assets*** — particularly land, physical infrastructure and financial credits — as the lack of access to such assets stifles the economic opportunities of many people, particularly those belonging to the category of poor.

4. ***Investment in the education, health and skills of the people*** and providing basic social services to all. Experience of a number of countries like China, Hong Kong, Japan, Singapore, Thailand, etc., shows that channelling of significant amounts of resources by the State in these fields greatly enhances human development.

5. Taking steps to ensure ***gender equality*** as it has been observed that fairer opportunities for women and better access to education, child care, credit and employment contribute to their human development. They also contribute to the human development of other family members and to economic growth. *HDR* 1996 points out correctly that "Investing in women's capabilities and empowering them to exercise their choices is the surest way to contribute to economic growth and overall development."[31]

6. A ***population policy*** emphasising the role of education, reproductive health and reduction in infant mortality in order to lowering fertility.

The links between economic growth and human development are strengthened further if, along with the above conditions, 'good governance' prevails at the political level in the sense that those in power give high priority to the needs of the whole population on the one hand, and people participate in decision making at many levels on the other hand. *HDR* 1996 points out that a determined effort to expand human capabilities (through improved education, health and nutrition) can help transform the prospects for economic growth, especially in the low human development, low income countries. In this context, it cites a World Bank study of 192 countries which concluded that ***only 16 per cent of growth is explained by physical capital (machinery, buildings and physical infrastructure), while 20 per cent comes from natural capital. But no less than 64 per cent can be attributed to human and social capital.***[32] Similar conclusions were obtained in extensive analysis of earlier experience of East Asian industrialising countries, including Japan.

RECASTING PLANNING IN TERMS OF HUMAN DEVELOPMENT

Mahbub ul Haq has made a strong plea for recasting the planning models and strategies in terms of human development. Such recasting would contain at least the following five distinct elements conspicuously lacking in most plans today:[33]

1. ***The plans would start with a human balance sheet.*** Thus, they would start with questions relating to the extent of human resources in the country, the level of education, inventory of skills, profile of relative income distribution and absolute poverty, levels of unemployment and underemployment, urban-rural distribution and level of human development in different regions, cultural and social attitudes and aspirations of the people, etc. Generally, the first chapter of a development plan presents macroeconomic aggregates of GNP, saving, investment and other components of national income accounts. Under recasting in terms of human development, this chapter would contain a comprehensive human balance sheet on the lines stated here.

2. ***Plan targets would first be expressed in terms of basic human needs and only later translated into physical targets for production and consumption.*** Thus, there would have to be a clear exposition of the targets for average nutrition, education, health, housing, etc. The basic needs targets, once identified in terms of national requirements and specified in terms of the nation's resources, will then have to be built into detailed planning for production and consumption. "In other words, we must proceed from ends to means, not the other way around."[34]

3. Recasting plans in terms of human development requires placing ***equal emphasis on production and distribution objectives***. The development plan will not only specify what is to be produced but also how national production is to be distributed equitably. This would require action, at least, on the following four fronts: *(i)* initiating action programmes and delivery mechanisms to increase

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the productivity of the poor — particularly small farmers and small entrepreneurs; *(ii)* employment planning, as the only effective means of improving distribution in many societies is to create adequate employment opportunities; *(iii)* redistribution of productive assets particularly land, as the existing distribution in many developing countries is badly skewed; and *(iv)* creation of social safety nets for the poor.

4. ***If human beings are to be declared the ultimate objective of economic planning, adequate steps are required to ensure their full participation in planning***. Thus the human development strategy must be decentralised. The beneficiaries need to be involved fully in planning for themselves and then in implementing the plan that is finally drawn up.

5. ***A comprehensive set of social and human development indicators needs to be evolved to monitor plan progress***. In addition to GNP growth rates, annual assessments on the performance on human development front, changes in relative and absolute poverty levels, etc., need to be carried out.

These five elements should form the first part of the plan and the conventional national income accounts should be moved to the second part of the plan. Recasting plans along the above lines by the developing countries will make them more meaningful for the people and also ensure better community participation in the planning process.

However, as noted by Mahbub ul Haq, changes along the above lines are not minor, but basic. The difficulties are enormous but the task is challenging, exciting and worthwhile. One should not forget that many difficulties had to be encountered in the construction of national income accounts also in the early stages. After the difficulties of the initial effort are overcome, human balance sheets too should become commonplace.[35]

NOTES

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3 Chapter

THE ENVIRONMENT AND DEVELOPMENT

During the last few decades, many experts have drawn attention to the close links between environment and development. The mad rush for industrial growth has, over the years, led to environmental degradation on a large-scale accompanied by massive resource depletion. In their study *The Limits to Growth* published in 1972, D.H. Meadows, D.L. Meadows and R. Randers drew attention to the fact that there are a number of non-renewable resources whose present levels of consumption are such that the known reserves will be exhausted in not so distant future. Many later studies have also highlighted the danger of environmental degradation. Thus, the focus has now shifted to ***'environmental protection'***. According to the *World Development Report* 1992, environmental problems can undermine the goals of development in two ways: "*First* environmental quality — water that is safe and plentiful and air that is healthy — is itself part of the improvement in welfare that development attempts to bring. If the benefits from rising incomes are offset by the costs imposed on health and the quality of life by pollution, this cannot be called development. *Second*, environmental damage can undermine future productivity. Soils that are degraded, aquifers that are depleted, and ecosystems that are destroyed in the name of raising incomes today can jeopardise the prospects for earning income tomorrow."[1] Therefore, ***environmental protection should form a part of any comprehensive programme of industrial development.*** In this context, the economists now emphasise the concept of ***sustainable development.***

While examining the close links between environment and economic development, we shall address the following issues:

- Why is environmental protection necessary for sustainable development?
- Does economic growth lead to environmental degradation?
- What policy measures have been adopted by the Government of India for protection of environment?
- What are the global concerns regarding environment?

ENVIRONMENTAL PROTECTION AND SUSTAINABLE DEVELOPMENT

The term ***sustainable development*** first came into prominence in the World Conservation Strategy, presented in 1980 by the International Union for the Conservation of Nature and Natural Resources. It was defined clearly in the Brundtland Report *Our Common Future* (1987) in the following words: ***"sustainable development seeks to meet the needs and aspirations of the present without compromising the ability of future generations to meet their own needs."***

Sustainable development can be achieved only if the environment is conserved and improved. Moreover, a development path is sustainable "if and only if the stock of overall capital assets remains constant or rises over time."[2] This implies keeping the stock of ***natural capital*** at least constant. More strictly, "the requirement is for non-negative change in the stock of natural resources and environmental quality. In basic terms, the environment should not be degraded further but improvements would be welcome."[3] The argument quite simply is that the resource base of a country and the quality of its air, water, and land represents a common heritage for all generations. To destroy that endowment in the pursuit of short-term economic gains compromises the gains of future generations and is thus undesirable. Therefore, government must incorporate some form of ***environmental accounting*** into its policy decisions. This requires that, "the preservation or loss of valuable environmental resources should be factored into estimates of economic growth and human well-being. Alternatively, policymakers may set a goal of no net loss of environmental assets. In other words, if an environmental resource is damaged or depleted in one area, a resource of equal or greater value should be regenerated elsewhere."[4]

The conventional national income accounts do not fully cover the depletion of natural resources and the degradation of the environment. Thus, they send wrong signals to the policymakers. To correct this, the Statistical Division of the United Nations has been working to supplement the System of National Accounts with a satellite system of integrated economic and environmental accounting

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These experimental accounts contain some innovations. One of the most important concerns expenditure for environmental protection. Since each spending compensates for the negative impact of economic growth, it is considered to be a cost, to be deducted from national income.

These satellite accounts involve supplementing both standard balance sheets and income accounts. The first step for a country is to draw up a comprehensive balance sheet of natural resources measured in physical quantities. For some of these resources, it is also possible to impute a monetary value that can be added to physical capital to form an expanded capital account. If the resources are not scarce, their value is zero.

In this new system of accounts, depletion of capital will not only include depreciation of physical capital but also depletion of natural resources, along with the deterioration of environmental quality. When drawing up national income accounts, these environmental losses can then be subtracted to produce a new measure of growth — environmentally adjusted domestic product.

This new system of accounts has been tested in several countries. For Mexico in 1986-90, it was found that the environmentally adjusted domestic product was 13 per cent less than the conventionally measured net domestic product. The new accounting measures also showed that net investment — which conventional measures showed as positive, at 46 billion pesos[5] — was a negative 700 million pesos. Net savings, also assumed to be positive, was actually close to zero.

GROWTH AND ENVIRONMENTAL DEGRADATION

Human activity in general and the process of rapid industrialisation in particular have been causing massive environmental damage all over the world. Most of the environmental and ecological damage is irreversible leading to widespread concerns among the environmentalists regarding the sustainability of the present rates of economic growth. Some even question the blind pursuit of such growth. Although quantitative and monetary estimation of environmental degradation is not possible, some estimates for various countries have been attempted in recent years. As far as India is concerned, an estimate for the year 2009 was presented in World Bank's report *India Diagnostic Assessment of Select Environmental Challenges* released in June 2013. ***This report estimated the total cost of environmental degradation in India at about ₹ 3.75 trillion annually, equivalent to 5.7 per cent of GDP in 2009.***[6] In addition to this, India also experienced some damages from natural disasters (floods, landslides, tropical cyclones, and storms). These are not included in the above figures. According to the Report, ***over the period 1953-2009 damages from natural disasters stood at ₹ 150 billion a year on average (at constant 2009 prices)*** and took the form of loss of life and injury, losses to livestock and crops and losses to property and infrastructure.[7] In this context, the following comments by Dreze and Sen on environmental degradation in India are also pertinent, "In India, we have huge reasons

Box 3.1

Sustainable Development and Environmental Degradation

- Sustainable Development seeks to meet the needs and aspirations of the present generation without compromising the ability of future generations to meet their own needs.
- Sustainable Development can be achieved only if the environment is conserved and improved. Moreover, a development path is sustainable if and only if the stock of overall capital assets remains constant or rises over time.
- The main health and productivity consequences of environmental damage are:
  - Water pollution
  - Outdoor urban air pollution
  - Indoor air pollution
  - Solid and hazardous wastes
  - Soil degradation
  - Rangeland degradation
  - Deforestation
  - Loss of biodiversity
  - Atmospheric changes
    - I. Greenhouse effect
    - II. Ozone depletion

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to be worried about our treatment of the environment and its implication for the lives people can lead in this increasingly polluted and environmentally devastated country. Indeed, the acceleration of economic growth in recent decades has coincided with unprecedented environmental plunder. Groundwater has been extracted with abandon, leading to a sharp fall in water tables in many areas. Majestic rivers have been reduced to a trickle, or to sewage drains. Mining activities (often illegal) have spread with few safeguards, destroying forests and displacing communities. Air pollution has risen so far that India is now rated as the most polluted among 132 countries for which comparable data are available. ***India's natural wealth is estimated to have shrunk by about 6 per cent in value terms (more than 30 per cent on a per capita basis) between 1990 and 2008***. And all this might be no more than just a harbinger of things to come: many types of environmental damages are likely to accelerate in the near future, with, for instance, hundreds of dams being planned on the Ganges river and its tributaries alone".[8]

Environmental damage is frequently discussed under the following categories: water pollution and water scarcity, air pollution, solid and hazardous waste, soil degradation, rangeland degradation, deforestation, loss of biodiversity and atmospheric changes.

1. Water Pollution. Water quality has continued to deteriorate world over because of a number of factors. The most widespread contamination of water occurs from industrial waste. Where industry and mining are expanding, rivers become contaminated with toxic chemicals and with heavy metals such as lead and mercury. These pollutants are hard to remove from drinking water with standard purification facilities. The capacity of rivers to support aquatic life is decreased. Not only surface water near towns and cities has become increasingly polluted over the years, even groundwater has been contaminated as a result of seepage from the improper use and disposal of heavy metals, synthetic chemicals and other hazardous wastes. Sometimes, industrial effluents are discharged directly into groundwater.

Water pollution is the most serious environmental problem for large number of people in developing countries who lack access to clean water and sanitation. The direct impact of waterborne diseases is huge, especially for children and the poor (who are most at risk). The main health impacts of unclean water and poor hygiene are diarrheal diseases, typhoid and paratyphoid. In fact, ***about 88 per cent of diarrheal diseases globally are attributed to water, sanitation and hygiene.*** According to World Bank, even this is a conservative approach where malnutrition impact on early childhood diseases is omitted. If considered, this additional indirect impact would approximately double the mortality attributed to water supply, sanitation and hygiene.

As far as India is concerned, a recent report published by Water Aid, an international organisation, shows that ***an alarming 80 per cent of India's surface water is polluted***. According to the report, 75-80 per cent of water pollution by volume is from domestic sewage. Estimated sewage generation from Class I and Class II towns is 38,255 MLD (million litres per day) of which only 11,787 MLD (i.e., 30 per cent) is being treated. The remaining is disposed directly into water bodies, polluting three-fourth of our surface water resources.[9]

2. Outdoor Urban Air Pollution. There is substantial research evidence from around the world that outdoor urban air pollution has significant negative impacts on public health and results in premature deaths, chronic bronchitis, and respiratory disorders. Particulate matter less than 10 micrometers — officially called PM10, many times finer than a human hair — is generally taken as the primary measure of air pollution. These microscopic bits and bobs of progress burrow deep into the respiratory system. However, recent research shows that in addition to PM10, there are others of growing concern. Extra-fine particles smaller than 2.5 micrometers, or PM2.5, can go further into the lungs and airway and carry more dangerous toxins, such as heavy metals. Other pollutants of concern are sulphur dioxide (SO_2) and nitrogen oxide (NO_2). Sulphur dioxide concentrations are serious in countries that rely on high-sulphur fuels. Nitrogen oxide is a smelly, toxic gas, creating ozone on the ground — a major component of smog — and acid in the air. The gas, a product of vehicular engines and factories, irritates the eyes, nose, throat, causes shortness of breath and aggravates respiratory illnesses, such as asthma, especially in young children.

Outdoor air pollution in India claims 1.09 lakh lives of adults and 7,500 lives of children below 5 years, annually. Estimated new cases of bronchitis are about 48,000 every year. Annual hospitalisations due to pollution are estimated at close to 370 thousand and emergency room visits/outpatient hospitalisations at 7,300 thousand per year.

The mean estimated annual cost of PM urban air pollution total was ₹ 1,103 billion in 2009 (which is 29 per cent of the ₹ 3.75 trillion total cost of environmental damage in India). This amounted to 1.7 per cent of GDP in 2009.

3. Indoor Air Pollution. WHO (2002) estimates that 1.6 million people die each year globally due to indoor smoke from the use of traditional fuels in the home. The most common is incomplete combustion of fuels such as wood, agricultural residues, animal dung, charcoal and in some countries, coal. The strongest link between indoor smoke and health are for lower respiratory infections, chronic obstructive pulmonary disease (COPD), and for cancer of

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the respiratory system. Indoor smoke is estimated to cause about 37.5 per cent, 22 per cent and 1.5 per cent of these illnesses globally.

According to Forest Survey of India (2011), firewood constitutes the major source of cooking energy in India and more than 853 million people use firewood for cooking in India. As per the 2011 Census, 49 per cent of the households in the country use firewood for cooking. In some States, it is as high as 80 per cent. The forest rich States have higher incidence of firewood use for cooking.

To estimate the impact of indoor air pollution, the World Bank Study considers young children under the age of five years (for acute respiratory illness or ARI) and females (for ARI and COPD) on the logic that it is these population groups who suffer the most from indoor air pollution. The study finds that estimated cases of ARI child mortality and ARI morbidity (children and female adults) from indoor air pollution represent about 38-53 per cent of total ARI in India. Similarly, the estimated cases of COPD mortality and morbidity represent about 46-72 per cent of total estimated female COPD from all causes. Almost 8 million DALYs (disability adjusted life years) are lost each year to indoor air pollution — about 70-80 per cent from mortality and 20-30 per cent from morbidity. ***The mean annual cost of indoor air pollution was estimated at ₹ 865 billion in 2009 (which was 23 per cent of the total ₹ 3.75 trillion total cost of environmental damage in India).*** This amounted to 1.3 per cent of GDP in 2009.

The above estimates show that 52 per cent of total cost of environmental damage in 2009 was accounted for by outdoor and indoor air pollution.

4. Solid and Hazardous Wastes. Many cities generate more solid wastes than they can collect or dispose off. Even where provision for collection is satisfactory, safe disposal of collected wastes often remains a problem. In many developing countries, open dumping and uncontrolled landfilling are resorted to.

Inadequate collection and unmanaged disposal present a number of problems for human health and productivity. As noted by *World Development Report* 1992, "uncollected refuse dumped in public areas or into waterways contributes to the spread of disease. In low-income neighbourhoods that lack sanitation facilities, trash heaps become mixed with human excreta. Municipal solid wastes sites often receive industrial and hazardous wastes, which may then seep into water supplied."[10] Thus, in addition to spreading disease, solid and hazardous wastes pollute groundwater resources.

5. Soil Degradation. A study sponsored by United Nations Environment Programme (UNEP) in 1990 revealed that 1.2 billion hectares — almost 11 per cent of the earth's vegetated surface — underwent moderate or worse soil degradation over the forty-five year period 1945-90 because of human activity. One of the chief forms of soil degradation is soil erosion (which is often a result of wind and water erosion). Soil erosion denudes the agricultural land of its top fertile layer and thus affects agricultural productivity adversely. It also harms productivity by depositing silt in dams, irrigation systems and river transport channels and by damaging fisheries.

Salinisation and waterlogging are other serious forms of soil degradation. They reduce the productivity of agricultural lands and, if a threshold salinity level is exceeded, the land becomes unfit for cultivation. In India, for example, it has been estimated that ***about 13 million hectares of agricultural land cannot be cultivated, either because they are waterlogged or because they are highly saline.***[11]

Adding up the three categories of soil degradation in India (soil erosion, salinisation and waterlogging), World Bank Study estimates losses arising from such degradation at ₹ 715 billion or 1.1 per cent of GDP in 2010. Another way to express this loss is as a percentage of GDP from agriculture, forestry and fisheries, which are sources of income predominantly for the poor. This can be referred to as the 'GDP of the poor' and, as a per cent of that, the loss is about 6.4 per cent.[12]

6. Rangeland Degradation. Land use reported in India suggests that the main causes of rangeland degradation in India are irrational land use management practices leading to denudation of vegetation from rangelands, which exacerbated by intermittent droughts, has resulted in many pockets of desertification. World Bank study estimates the annual cost of rangeland degradation at ₹ 405 billion in 2010 (0.6 per cent of GDP).

7. Deforestation. Forests are of immense value in protecting the environment. They provide a livelihood and cultural integrity for forest dwellers and a habitat for a wealth of plants and animals. They protect and enrich soils, provide natural regulation of the hydrologic cycle, affect local and regional climate through evaporation, influence watershed flows of surface and groundwater, and help to stabilise the global climate by sequestering carbon as they grow. Therefore, they play a useful role in preserving the ecological and environmental balance and in maintaining the biodiversity and ecosystems. However, unmindful of these facts, deforestation has continued unabated and at a fast rate all over the world as man has cleared forests for extending agriculture and obtaining firewood, industrial wood, timber and construction materials.

According to the Forest Survey of India's (FSI) biennial report for 2015, India's forest cover is about 21 per cent of

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total land area (about 70 million hectares). Dense forest constitutes only 12 per cent of total forest cover area.[13] What is a matter of serious concern is the fact that the North-Eastern mountainous States with the most dense forest, like Nagaland, Arunachal Pradesh, Tripura and Assam, continue to experience deforestation due to the widespread practice of shifting cultivation. This loss is especially damaging for hilly areas where destructive agricultural practices can result in total ecosystem destruction. ***World Bank study estimates the total degraded forest area in 2009 at 28 million hectares (which is 40 per cent of total area under forests).***

8. Loss of Biodiversity. "Biological diversity — a composite of genetic information, species, and ecosystems — provides material wealth in the form of food, fibre, medicine and inputs into industrial processes. It supplies the raw material that may assist human communities to adapt to future and unforeseen environmental stresses. Furthermore, many people value sharing the earth with numerous other forms of life and want to bequeath this heritage to future generations."[14] Loss of biodiversity jeopardises all this. However, it is not possible to evaluate the loss of biodiversity at a global or national level. This is because the links between biodiversity and biological systems and the economic and social values that they support are extremely complex. Even the measurement of biodiversity is problematic, with a multi-dimensional metric being regarded as appropriate but with further work being considered necessary to define the appropriate dimensions.

On account of the above reason, the focus, initiated by the Millennium Ecosystem Assessment (MEA, 2005) has shifted from biodiversity to measuring ecosystem services, which are related to biodiversity and are derived from the complex biophysical systems. The most important fact about these services is that they have also been facing major losses. ***During the last century, the planet has lost 50 per cent of its wetlands, 40 per cent of its forests, and 35 per cent of its mangroves. Around 60 per cent of global ecosystem services have been degraded in just 50 years.***[15]

In India, under the pressure of rapidly growing population and unplanned development of natural environment, the habitats of our species are being lost or modified. This has also resulted in the disappearance of certain species and ecosystems. In India, 103 species of mammals and birds have been listed as endangered under the Wildlife (Protection) Act, 1972 and 5 such species are known to have become extinct in recent past. As far as marine ecosystems are concerned, there is hardly any knowledge and understanding about them. Therefore, no protection measures have been undertaken to prevent exploitation and destruction of these resources.

9. Atmospheric Changes. Indiscriminate industrialisation, urbanisation and environmental pollution are bringing about certain atmospheric changes which are likely to cause uncertain and irreversible hazards to future generations. Though complete knowledge regarding these hazards does not exist, the scientists have already drawn attention to two hazards — greenhouse effect and global warming, and ozone depletion.

(i) Greenhouse Effect and Global Warming. The climate of earth is determined by the incoming energy from the sun, the outgoing energy radiated from the earth, and exchanges of energy among the atmosphere, land, oceans, ice and living things. The composition of the atmosphere is particularly important because some gases and aerosols (very small particles) affect the inflow of incoming solar radiation and outgoing infrared radiation. Water vapour, carbon dioxide (CO_2), methane (CH_4), Ozone (O_3) and nitrous oxide (N_2O) are all greenhouse gases (GHGs) naturally present in the atmosphere. They warm Earth's surface by impeding the escape of infrared (heat) energy into space. ***The warming effect created by the natural levels of these gases is "the natural greenhouse effect".*** This effect warms the world about 33°C more than it would be otherwise, keeps most of the world's water in the liquid phase, and allows life to exist from the equator to near the poles.

As noted by *World Development Report* 2010, gases released from human activities have greatly amplified the natural greenhouse effect.[16] The global average CO_2 concentration has increased significantly since the beginning of the Industrial Revolution, especially in the past 50 years. Over the 20th century, the CO_2 concentration increased from about 280 ppm (parts per million) to 387 ppm — almost 40 per cent — mainly because of the burning of carbon-based fossil fuels and, to a lesser extent, deforestation and changes in land use. ***The combustion of coal, oil and natural gas now contributes about 80 per cent of the CO_2 emitted annually, with land use changes accounting for the remaining 20 per cent.*** In 1950, the contributions from fossil fuel and land use were about equal; since then, energy use has grown by a factor of 18. The concentrations of other heat trapping gases, including methane and nitrous oxide, have also increased significantly as a result of fossil fuel combustion, farming and industrial activities, and land use changes. The heat trapping caused by CO_2 and these other gases is likely to result in considerable global warming which could cause the melting of ice-sheets and a consequent rise in sea level; increase in floods, droughts, and forest fires in many regions; spread of infectious and diarrhoeal diseases as a result of extreme heat; extinction of a quarter of all human species; significant declines in food production;

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and many disastrous but yet unknown adverse impacts on environment and ecology. In fact, ***there is convincing evidence that the capacity of societies and ecosystems to adopt to global warming is severely tested beyond warming of 2°C.*** It is on account of this reason that international negotiations on climate change are presently trying to work-out strategies to limit global warming to 2°C.

(ii) Ozone Depletion. Ozone depletion is mainly the result of increasing atmospheric concentrations of chlorine originating from CFCs (chlorofluorocarbons). Although the industrial man-made chemicals CFCs are useful compounds, they do not dissolve in rain nor react with other gases in the atmosphere. The CFC gas molecules therefore rise very high up in the atmosphere to cause substantive damage to deplete ozone layer. An important consequence of ozone depletion is an increase in solar ultraviolet (UV) radiation received at the earth's surface. Ozone depletion could result in an increase in skin cancers of about 25 per cent (3,00,000 additional cases a year) within several decades and an increase in eye damage from cataracts of about 7 per cent (1.7 million cases a year). Increased UV radiation could also have adverse impact on plant productivity, forestry and natural ecosystems, including disruption of marine or aquatic food chain. Thus, the CFCs indiscriminately used by certain industries are a serious threat to the life support system on earth.

ENVIRONMENT POLICY IN INDIA

1972 is a landmark year in the history of legislative action in India. In the wake of the Stockholm Conference, the National Committee on Environmental Planning and Coordination (NCEPC) was set up in 1972. This was the first institutional arrangement for formally addressing environmental concerns. The NCEPC was entrusted with the responsibility of reviewing environmental policies and programmes. It is interesting to point out here that the Indian Constitution did not originally contain explicit provision on environmental protection. It was only in 1976 that environmental protection was incorporated in the Constitution by the Constitution (42nd Amendment) Act of 1976. Article 48A was added to the Directive Principles of State Policy in 1976 which states, ***"The State shall endeavor to protect and improve the environment".*** To address a wider set of emerging problems, the Department of Environment was established in 1980 followed by the setting up of a full-fledged Ministry of Environment and Forests (MoEF) in 1985. This ministry is currently the apex body for making policy decisions and initiating supportive legislation in respect of environmental matters. ***The broad objectives of the Ministry are: (i) conservation and survey of flora, fauna, forests and wildlife; (ii) prevention and control of pollution; (iii) afforestation and regeneration of degraded areas; (iv) protection of the environment; and (v) ensuring the welfare of animals.*** A comprehensive National Environment Policy was announced in May 2006.

Improving Water Quality. The first major environmental legislation was the ***Water (Prevention and Control of Pollution) Act of 1974.*** It led to the establishment of State Pollution Control Boards (SPCBs) to set and enforce effluent standards. To coordinate the activity of these Boards and to advise the Central Government, a Central Pollution Control Board (CPCB) was also set up. The Boards had legal powers to initiate legal action against all those who violated the law and indulged in water pollution. For meeting the expenses of the Boards, the ***Water Cess Act was enacted in 1977*** which required industries to pay a cess on their water consumption. The Central Pollution Control Board (CPCB) under MoEF, has established a nationwide network for water quality monitoring comprising 1,019 stations in 27 States and six Union Territories. The monitoring is done on a monthly and quarterly basis for surface water and on a half yearly basis for groundwater. A National River Conservation Plan (NRCP) was initiated in late 1996. The NRCP presently covers 38 rivers spread over 178 towns in 20 States with projects sanctioned at a total cost of ₹ 6,311 crore. A total of 4,064 mld (million litres per day) of sewage treatment capacity has so far been created under NRCP.[17] As small-scale industries do not have adequate resources, space or skilled manpower to treat their wastewater, a scheme of Common Effluent Treatment Plants (CETPs) was initiated in June 1990. The CETPs are partially funded by the Government of India. Eighty-eight CETPs covering more than 10,000 polluting industries were set up during the Tenth Plan.

The ***National Water Policy 2002,*** lays emphasis on integrated water resources development and management for optimal and sustainable utilisation of the available surface and groundwater; creation of well developed information system; water conservation and demand management; quantity and quality aspects as well as environmental considerations; involvement of beneficiaries and stakeholders in the project planning and participatory approach in water resources management, training and research, resettlement and rehabilitation aspects of project affected persons.

Improving Air Quality. The ***Air (Prevention and Control of Pollution) Act, 1981*** is the main legislation for regulating air quality, through the Pollution Control Boards (PCBs) in the States. The Central Pollution Control Board (CPCB) has identified 2,301 medium and large polluting industrial units under 17 highly polluting categories and pollution control devices are being provided to them. CPCB

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also monitors ambient air quality at 308 stations covering 115 cities/towns in 28 States and four Union Territories in the country to: (*i*) determine the status and trend in ambient air quality on significant parameters; (*ii*) assess health hazard and the damage to materials; (*iii*) develop preventive and corrective measures; and (*iv*) understand the natural cleansing process.[18]

However, as correctly pointed out by Puran Mongia, the regulatory framework for water and air pollution proved to be quite ineffective. The SPCBs were perpetually short of funds. They lacked technical expertise and manpower to effectively monitor pollution. Many of them did not even have access to laboratories for testing of water samples. They simply focused on end-of-the-pipe treatment through installation of specific devices. Often it was enough for a polluting entity to simply install a device to demonstrate compliance. It did not matter whether it worked or not. Moreover, the financial and political clout of polluters also made enforcement difficult.[19] The legal process was time consuming and the polluters generally got away with minor penalties which were no deterrent. As a result, pollution continued to increase manifold and its nature became more complex.

Environment (Protection) Act, 1986. The Bhopal Gas Tragedy of December 3, 1984 involving death of over 3,500 people and injuring another 2 lakh people brought to the fore the complete inadequacy of existing laws and their poor enforcement. Consequently, a comprehensive ***Environment (Protection) Act was enacted in 1986.*** It empowered the Central Government to take all such measures as it deems necessary or expedient for the purpose of protecting and improving the quality of the environment and preventing, controlling and abating environmental pollution. According to Mongia, the Environment (Protection) Act, 1986 was a significant piece of legislation on account of the following reasons:[20]

1. It extended the authority of the Central Government to legislate for the entire country.

2. It took a comprehensive view of the environment and extended the scope of regulation to cover almost all forms of pollution.

3. The government used the Act to frame wide-ranging laws for pollution control, hazardous substance regulation, environmental impact assessment, and the protection of the coasts and other ecologically fragile areas.

4. The Act gave the SPCBs vast administrative powers to compel compliance with the laws directly instead of having to go to courts as previously. It also gave the CPCB overriding authority over SPCBs.

5. A development of the utmost importance was that the Act gave citizens the right to initiate proceedings against the defaulting industries and the boards.

Hazardous Waste and Biomedical Waste Management Rules. The Bhopal Gas Tragedy proved to be a warning to the government that industrial corporates would continue to endanger lives of thousands of people by mishandling of hazardous substances if the former did not take effective legislative measures to compel the latter to provide for adequate safety measures in the handling of hazardous chemicals and waste. Accordingly, the government enacted the ***Hazardous Waste (Management and Handling) Rules, 1989.*** The government has also constituted Hazardous Substances Management Division (HSMD). The major functions of the HSMD include regulatory activities for framing necessary rules relating to environmentally sound management of hazardous wastes/ chemicals, plastics and municipal solid wastes under the Environment (Protection) Act, 1986 and promotional activities by providing necessary financial support to the concerned agencies for their implementation. A fresh draft Notification of Hazardous Waste Management Rules was also published in 2007. This was designed to take the place of the Hazardous Waste (Management and Handling) Rules, 1989. ***Municipal Solid Waste (Management and Handling) Rules, 2000*** stipulated that these were to be complied by December 2003. Under these rules, all local bodies were expected to undertake segregation of waste and its collection, storage, transportation, processing, and disposal. Biomedical Waste (Management and Handling) Rules were laid down in 1998 and amended in 2000 and 2003.

Environmental Impact Assessment. Environmental Impact Assessment (EIA) involves evaluation of a project or a programme which is likely to cause damage to the environment. This is intended to ensure that environment concerns are integrated in the developmental activities in order to achieve sustainable development. The process of EIA which was started in 1978-79 with river valley projects has now extended to 39 activities in eight categories including mining/exploration/power generation, primary processing, material processing, material production, manufacturing/ fabrication, services sector, infrastructure, and construction. The major statutory regulations governing EIA are ***EIA Notification of 2006 and Coastal Regulation Zone (CRZ) Notification, 1991.***

The world over, EIAs are crucial tools to assess the ecological feasibility and desirability of projects and processes, and can be significant in taking a country towards the goal of sustainability. However, in India, they are seen as 'nuisance' by industrialists, politicians and many

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development economists who argue that EIAs are a major cause of delay in the implementation of projects. According to Aseem Shrivastava and Ashish Kothari, ***the scale and pace at which industrial and developmental projects are being given environmental clearance, now makes any meaningful regulation impossible.*** For instance: (1) The MoEF clears 80-100 projects every month, with environmental and social conditionalities that project proponents are supposed to adhere to; (2) As of early 2009, MoEF had over 6,000 projects to monitor through six regional offices and a staff of two to four officers per office for the task; (3) Projects granted environmental clearance are monitored only once in three to four years; (4) No centralized record of non-compliance is maintained by the MoEF; (5) Less than 50 per cent of the projects cleared in 2003 had monitoring reports generated by the MoEF; and (6) Only 150 out of the 223 projects cleared in the year had at least one compliance report submitted by project authorities.[21]

What is worse is the fact that it is not science but politics that plays a more important role in deciding the fate of many important projects and the environment clearance process changes every time a new minister takes charge. In fact, the EIA notification of 2006 underwent changes more than 100 times over the seven year period 2006-2013.[22] ***Frequent changes have resulted in ad hocism and confusion in the country's environment policy regulation.*** The main reason for the mess in environment clearance is that India – unlike the US and other developed countries – does not have an independent expert body which is at an arm's length from the government for appraising and approving projects.

As far as CRZ notification is concerned, it was a bold step to try safeguarding the ecologically sensitive coastal areas of the country. Though by no means perfect, and despite perfunctory implementation by most States, the notification was instrumental in stopping or delaying many destructive projects. However, like EIAs, CRZ notification was also seen as a 'nuisance' by the industrial and commercial interests. According to Aseem Shrivastava and Ashish Kothari, pressure by these interest groups on the government resulted in as many as 19 changes to the original notification. Almost all of these were with the intention of relaxing regulations for setting up ports and allowing mining, oil and gas exploration, and SEZs in what were previously 'no-development' zones. ***In widespread violation of the CRZ notification, or by using its many loopholes, a number of ports, industries, sports and tourism complexes and other projects have come upon India's coasts.***[23]

It is also a matter of serious concern that increased economic and industrial activity is now being permitted in the biodiversity rich Western Ghat area spanning six States (Gujarat, Goa, Tamil Nadu, Kerala, Maharashtra and Karnataka). For instance, the draft notification issued by MoEF on September 4, 2015 debars only mining, thermal power plants, big townships and critically polluting industries from the region. Only 25 per cent of the area is now classified as eco-sensitive zones (ESZs). The notification allows hydro-power projects, all other categories of industries and also asks States to implement Forest Rights Act for allowing industrial activity.[24]

Joint Forest Management and Afforestation. The Joint Forest Management (JFM) regime was initiated with the circular of the MoEF on June 1, 1990 on people's involvement in forest conservation and management. It has evolved gradually over time and at present 1,06,479 such Committees (22 million participants) are functioning in 28 States covering 22.02 million hectares of forests. According to the Eleventh Five Year Plan, "This participatory regime is seen as a potential strength of forest management for the forest fringes. The challenge now is to effectively empower the local communities with appropriate rights and responsibilities, and ensure that substantial benefits from forest conservation accrue to them".[25] Integrated Forest Protection Scheme (IFPS) was implemented during the Tenth Plan and continued afterwards.

In order to promote afforestation, tree planting, ecological restoration and eco-development activities in the country, the ***National Afforestation and Eco-development Board (NAEB) was set up in August 1992.*** Special attention is being given by the NAEB for the regeneration of degraded forest areas and lands adjoining forest areas, national parks, sanctuaries and other protected areas as well as the ecologically fragile areas like the Western Himalayas, Aravallis, Western Ghats, etc. Bamboo Plantation, Medicinal Plants and Biofuel have been given adequate focus under the National Afforestation Programme.

Biodiversity and Taxonomy. Habitat conversion or land use changes, land degradation, and pollution result in the decline of ecological goods and services needed for human welfare. The ***Biological Diversity Act, 2002 and Rules, 2004*** provide for constitution of State Boards (SBs) and Management Committees (BMCs) for conservation, documentation and sustainable utilisation of biodiversity and for building up capacities of these bodies.

Taxonomy is the science which helps in the exploration, identification and description of living organisms. However, the scope of taxonomy does not end with this. A sound taxonomic base is a prerequisite for environmental assessment, ecological research, effective conservation, management and sustainable use of biological resources. The implementation of the Biological Diversity Act, 2002 and Rules, 2004 calls for an adequate number of

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trained taxonomists. Existing programme in botanical gardens and taxonomic capacity building assume immense significance in this respect. MoEF provided assistance to 72 botanical gardens during the Tenth Plan and under an AICOPTAX (All India Coordinated Project on Taxonomy), 11 coordinating centres and two centres for training have been supported at various institutions.

Assistance to Botanic Gardens. The scheme on Assistance to Botanic Gardens and centres for *ex-situ* conservation was initiated in 1992 to augment *ex-situ* conservation of rare endemic plants. One-time financial assistance is provided to the Botanic Gardens and Centres of *ex-situ* conservation, for improvement of their infrastructural facilities to facilitate *ex-situ* conservation of rare endemic plants. The achievements made in these Botanical Gardens are periodically monitored with the help of Botanical Survey of India.

The ***Botanical Garden of the Indian Republic*** (BGIR) has also been set up at Noida, Uttar Pradesh, to facilitate *ex-situ* conservation and propagation of rare and threatened indigenous plants of the country, serve as a 'Centre of Excellence' for research and training and thereby cater to the need for conservation of endangered species in the region, and build public awareness on the conservation needs through education on conservation of plant diversity. The BGIR is presently carrying out the basic scientific/ technical work to facilitate project execution in context of research/field operations.

Wildlife Conservation. The Indian Constitution entails the subject of forest and wildlife in the concurrent list. The Federal Ministry acts as a guiding torch dealing with policies and planning on wildlife conservation while the State Forest Departments have been vested with the responsibility of implementation of national policies and plans. To combat wildlife related crimes, a Wildlife Crime Control Bureau under the Director, Wildlife Preservation, has been constituted with five Regional Offices and three sub-regional offices. The MoEF provides necessary technical and financial support to the State Governments for wildlife conservation under various Centrally Sponsored Schemes (CSS) which include schemes for Development of National Parks and Sanctuaries, Project Elephant, Central Sector Scheme on Strengthening of Wildlife Division, and through Grants in Aid to the Central Zoo Authority and the National Tiger Conservation Authority (NTCA). The Centre Sponsored Scheme ***'Project Tiger' was launched in April 1973 after an amendment of the Wild Life (Protection) Act, 1972*** with the objective of protecting the population of tigers. Accordingly, NTCA was constituted. The Government of India set up the Central Zoo Authority (CZA) in the year 1992 through an amendment in the Wild Life (Protection) Act, 1972.

Biosphere Reserves. This programme was started in 1986 with UNESCO (Management and Biosphere) support for integrating social, cultural, and ecological values of ecologically rich landscapes. The primary focus was on monitoring and designing conservation strategies. However, with Tenth Plan outlay of only ₹ 35 crore, the programme was not able to deliver an effective outcome for the existing biosphere reserves. According to the Eleventh Plan, there is a need to reinforce the information and strategic back-up for the management of protected areas in the core of biosphere reserves.

Mountain Ecosystems. The MoEF established the ***G.B. Pant Institute of Himalayan Environment and Development (GBPIHED)*** in 1988 as an autonomous institute with a mandate of achieving sustainable development and environmental conservation in the Indian Himalayan Region (IHR). The institute designs and implements R&D activities on priority environmental problems, develops and demonstrates best practices and delivers technology packages for improved livelihood of the people of the IHR.

Conservation of Mangroves and Coral Reefs. In the marine ecosystems, mangroves and coral reefs are quite important. The coral reefs protect the coastal areas from sea erosion while mangroves protect us from cyclone damage. Moreover, they contain many unique species adapted to the unusual habitat and are key nursery areas for many species of fish. Mangroves in India account for about 5 per cent of the world's mangroves vegetation and are spread over an area of about 4,500 km^2 along the coastal States/Union Territories. Sunderbans in West Bengal account for a little less than half of the total area under mangroves in India. The Indian reef area is estimated to be 2,375 km^2. The four major coral reef areas are Gulf of Mannar, Gulf of Kachchh, Lakshadweep, and Andaman and Nicobar Islands.

The ***Coastal Regulation Zone Notification (1991)*** under the Environment (Protection) Act, 1986 recognises the mangroves and coral reefs areas as ecologically sensitive and categorises them as CRZ-I (Coastal Regulation Zone-I) which implies that these areas are accorded protection of the highest order.

Environmental Research. MoEF has been supporting research in environment since 1985 through a Central Plan Scheme. The objectives of the scheme are to generate information required to develop strategies, technologies and methodologies for better environmental management. It also aims at attempting solutions to the practical problems of resource management, conservation of natural resources and eco-regeneration of degraded areas. Further, the scheme also aims at strengthening infrastructure to facilitate research and scientific manpower development.

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Environmental Awareness and Education. Effective implementation of environmental management and conservation programmes depends on education, awareness raising and training in relevant areas. Without an understanding of how to conserve natural resources and the compelling need to do so, few people would be motivated to participate actively in programmes of environmental conservation. Environmental education and awareness thus assume critical importance. With this end in view, the MoEF is implementing a scheme ***'Environmental Education, Awareness and Training'*** for enhancing the understanding of people at all levels about the relationship between human beings and the environment and to develop capabilities/ skills to improve and protect the environment. The Environment Education in School System project initiated in 1999 strengthens environment education in the formal school curriculum through infusion of appropriate education material. ***The National Museum of Natural History (NMNH) was opened in 1978*** to create public awareness in preservation and conservation of environment and nature.

Environmental Information System. Recognising the need of appropriate environmental information, the MoEF has set up an ***Environmental Information System (ENVIS)*** as a plan programme and as a comprehensive network in environmental information collection, collation, storage, retrieval and dissemination to varying users, which include decision-makers, researchers, academicians, policy planners, research scientists, etc. The Steering Committee on Environment and Forests for the Eleventh Plan suggested a unified National Environment Monitoring Programme (NEMP) for ecology, environmental chemistry, public health, and socio-environmental studies.

Disaster Management. Many regions in India are highly vulnerable to natural and other disasters on account of geological conditions. The Tenth Plan (2002-07), prepared in the backdrop of the Odisha super cyclone, Gujarat earthquake, and end of the International Decade of Natural Disaster Reduction, recognised disaster management as a development issue for the first time. The Plan devoted a separate chapter to disaster management and made a number of important prescriptions to mainstream disaster risk reduction into the process of development. An important initiative has been the enacting of the ***Disaster Management Act, 2005*** for establishing requisite institutional mechanisms for drawing up and monitoring the implementation of disaster management plans, ensuring measures by various wings of the government for prevention and mitigating the effects of disasters, and for undertaking a holistic, coordinated, and prompt response to any disaster situation. ***The National Disaster Management Authority (NDMA),*** under the chairmanship of the Prime Minister, has been set up in terms of the Act.

Climate Change. India is highly vulnerable to climate change. As per recorded observations, India has seen an increase of 0.4 degree Centigrade, in the mean surface air temperature over the past century (1901-2000). Change in mean temperature and precipitation will require change in cropping patterns. ***It has been estimated that a 2.0 to 3.5 degree Celsius increase in temperature, and the associated increase in precipitation, can lower agricultural GDP by 9 to 28 per cent.***[26] Yields of most crops will fall in the long run. The impact in the short run may be small, but the heat stress will affect the productivity of animals and milk production may even decrease over the present levels. Climate change will also affect the water balance, particularly the amount of runoff and recharge, which determines the overall water resources available in the ecosystem. This will change vegetative cover, affect availability of fodder, fuel wood and minor forest produce. Climate change is also expected to raise sea levels, which could submerge coastal lands in some areas, thereby threatening coastal cities and habitations. Apart from the loss of land and property, millions may be displaced (according to Aseem Shrivastava and Ashish Kothari, rise of close to one metre in sea levels, which could occur by the early twenty-second century, could inundate about 5,764 km, displacing over 7 million people).[27] Increase in sea and river water temperatures is likely to affect fish breeding, migration and harvest.

It is true that, on per capita basis, India is, and has been, one of the lowest GHG emitters in the world. ***Its emission on 2.33 tonnes of CO_2 equivalent per person in 2012, was nearly one-fourth that of Europe and one-eighth that of USA.*** However, as shown above, India is highly vulnerable to the adverse effects of climate variability and climate change. On account of this reason, and also as part of its commitment to help address the global climate challenge, India has participated actively in all global negotiations to limit environmental damage resulting from climate changes.

The above discussion shows that a large number of legislations have been enacted for environmental protection. However, as acknowledged in the National Environment Policy 2006 itself, "any policy is only as good as its implementation".[28] The main problem in the case of environmental laws has been the poor enforcement mechanism. As noted by Puran Mongia, India is a 'soft State', a State characterised by weak institutions, a high degree of corruption, and absence of well-developed social norms. "In such a State, decisions that go against the vested interests of industry, bureaucracy, or politicians are hard to

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make and do not get implemented."[29] We have already noted earlier how efforts for water and air pollution control proved to be unsuccessful because of the financial and political clout of the polluters. The same story is true in the case of all other environmental laws which are violated with impunity to serve various industrial and commercial interests.

THE GLOBAL CONCERNS

In this last section, we propose to discuss some major issues relating to global environment that have attracted the increasing attention of economists, environmentalists, industrialists and the governments. These concerns stem from the fear regarding the 'global sustainability' of economic development and business activity.

Global Environmental Threat: Global Warming and Climate Change

The rapid increase in production of pollutants, particularly by the industrial units has led to dramatic increase in the levels of concentration of a number of greenhouse and ozone depleting gases. The inevitable result has been global warming and damage to the ozone layer. The burning of fossil fuels by automobiles and industry are the major sources of greenhouse gases. Other sources include deforestation, animal husbandry, decomposition of waste, and coal mining. A number of gases, including CFCs (Chloro Fluoro Carbons), carbon dioxide, methane, sulphur dioxide, and nitrous oxides, contribute significantly to the stock of greenhouse gases. However, carbon dioxide has the biggest impact due to its relatively long lifetime in the atmosphere and the massive quantities produced globally.

Global environmental threat stemming from global warming would be clear from the following facts:

1. Global warming is at the root of climate change. According to the World Meteorological Organisation, the January to October data for the year 2015 showed the average surface temperature to be around 0.73 degree Celsius above the 1961-1990 average of 14 degree Celsius and approximately 1 degree Celsius above the pre-industrial 1880-1899 period. Research has shown that adverse impacts of climate change get more and more intense with rising global temperature. For example, extreme heat waves, flooding, rainfall events, but also drought and water scarcity, are all expected to become more frequent in many regions and countries, including India.

2. Sea levels are rising, threatening coastal systems. The warming has set off melting of polar ice caps, resulting in a rise in sea levels that threatens to drown coastal areas and islands. Sea surface temperatures have also been rising, accelerating sea level rise (it is estimated that cumulative sea level increase over the period 1880 to 2013 was as high as 8.98 inches). Coastal flooding and submergence of entire island nations is the most immediate impact of sea level rise. Scientists estimate that with rising sea levels, small island countries such as the Maldives, will not survive.

Kiribati, a Pacific island nation State, has become famous for buying land in nearby countries as it prepares to resettle its population amidst the threat of submergence. Global warming also threatens marine life, especially corals, as well as making shellfish (a source of essential protein for more than a billion people across the world) cultivation more difficult.

3. This is all happening due to rise in emissions. There is consensus among scientists about the dangers of climate change from anthropogenic (owing to human activity) emissions. Greenhouse gases (GHG) – carbon dioxide (CO_2), methane (CH_4) and nitrous oxide (N_2O) – have accumulated to unprecedented levels in the atmosphere. These gases have a heat-trapping effect on the earth's atmosphere. Industrialisation, driven by rising fossil fuel consumption, has seen carbon dioxide emissions soar. About 30 per cent of the emitted anthropogenic carbon dioxide has been absorbed by ocean causing ocean acidification. Deforestation to clear land for cultivation and settlement has removed the world's carbon sinks. Modern lifestyles are energy intensive, and fossil fuel consumption is only set to rise as population increases. According to a UN Climate Panel report, ***to curb global warming at 2 degrees Celsius, the world can only emit a total of between 800 billion and 880 billion tonnes of carbon. Of this, about 530 billion tonnes had already been emitted by 2011.***

4. Climate related disasters are increasing. Rising temperatures and sea levels have set off a chain of extreme weather events and environmental changes that are making the world a more risky and dangerous place. The total number of natural disasters rose from 6 in 1900 to as high as 344 in 2012. The number of natural disasters by disaster type over the period 1995-2015 were as follows – 3,062 floods, 2,018 storms, 405 extreme temperatures, 344 droughts, 387 landslides, 251 wildfires and 111 volcanic activities.[30] India too is feeling the heat of global warming. According to Jacob Schewe, the summer's devastating heat wave in 2015 and the weakening of average monsoon rainfall along with more frequent rainfall extremes can be seen as harbingers of India's future climate.

5. The poor are disproportionately affected by disasters caused by climate change. It is hard to adequately quantify the adverse effects of climate change, but the most acute effects include food stress. The agriculture sector is particularly vulnerable to extreme weather events. Modelling studies suggest that climate change could result in global

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crop yield losses as large as 5 per cent by 2030 and 30 per cent by 2080. Health effects – higher incidence of malaria, diarrhoea and stunting – and the labour productivity effects of high temperatures are the next strongest drivers. A recent World Bank report finds that in 52 countries where data were available, 85 per cent of the population lives in countries where poor people are more exposed to drought than the average.[31] To give an example from our own experience, poor people suffered economically the most during the Mumbai floods in 2005 and Tamil Nadu floods in 2015.

Global Environmental Threat: Role of Developed Countries

Global environmental threat is basically a result of the policies pursued over the years by the high income countries (particularly the industrialised countries of the West) as is clear from the discussion below:

1. With just 16 per cent of the world's population, high income countries accounted for 49.75 per cent (or half) of carbon dioxide emission in 2005. Low income countries accounted for 15 per cent of the world's population but contributed to only 2.7 per cent of carbon dioxide emissions.

2. As far as non-carbon dioxide emissions (here methane and nitrous oxide emissions) are concerned, high income countries accounted for 28 per cent of these emissions in 2005 while the share of low income countries was only 13 per cent.

3. Of the cumulative 1,169.1 billion metric tonnes of carbon dioxide emissions in the world over the period 1850 to 2005, high income countries accounted for as much as 750 billion metric tonnes (i.e., 64.2 per cent) while the share of low income countries was just 24.0 billion metric tonnes (2.1 per cent) and the share of middle income countries was 395.1 billion metric tonnes (34 per cent).

4. OECD group of countries (which consists mostly of developed industrialised countries of the West) accounted for 49 per cent of carbon dioxide emissions and 33 per cent of non-carbon dioxide emissions in 2005. ***Its share in cumulative emissions of carbon dioxide since 1850 is as high as 65.4 per cent.***

5. Over the years, the biggest polluter in the world has been the United States as is clear from the following facts: ***(i) it alone accounted for 23.6 per cent of carbon dioxide emissions in 2005; (ii) per capita carbon dioxide emission in USA was as high as 19.7 metric tonnes in 2005 which was as much as eleven times the per capita carbon dioxide emission in Brazil and eighteen times the per capita carbon dioxide emission in India; (iii) USA accounted for 324.9 billion metric tonnes of carbon dioxide emissions over the period 1850 to 2005 which is as much as 28 per cent of the total global carbon dioxide emissions over this period; and (iv) of the total worldwide methane and nitrous oxide emission of 1,978.9 million metric tonnes in 2005, USA alone accounted for 242.8 million tonnes (i.e., 12.3 per cent).***

6. Other developed countries like Australia, Canada, Germany, Japan, United Kingdom and France are also major polluters. In fact, the per capita emission of carbon dioxide in Canada was as high as 17.1 metric tonnes in 2005 which was more than fifteen times the per capita emission in India. Per capita emission of carbon dioxide in Australia was seventeen times the per capita emission in India in 2005, while in United Kingdom the per capita emission was eight times the per capita emission in India.

7. In the developing world, the only major polluter country is China. With the rapid economic growth registered by the Chinese economy during the recent period, its carbon dioxide emissions have grown alarmingly — from 2,211 million metric tonnes in 1990 to as high as 5,060 million metric tonnes in 2005 and further to 9,700 million metric tonnes in 2011. In fact, ***it is now the largest polluter in the world in terms of carbon dioxide emissions.*** It is followed by USA with carbon dioxide emissions of 5,420 million tonnes in 2011. China's share in total worldwide carbon dioxide emissions was as high as 29 per cent in 2011 while USA's share was 16.2 per cent. However, because of the large population of China, its per capita emissions continue to be quite low. They were 3.9 metric tonnes in 2005 as against 19.7 metric tonnes for USA in 2005. In 2011, per capita carbon dioxide emissions in China had risen to 7.2 metric tonnes but they were still much less than 17.3 metric tonnes reported in USA.

The above information clearly brings out the fact that the main culprits are the industrialised countries of the West particularly the USA. In fact, ***of the cumulative 1,169 billion metric tonnes of carbon dioxide emissions the world over during the period 1850 to 2005, USA alone accounted for 324.9 billion tonnes (which is 28 per cent of the total) while the share of European Union was 284.8 billion metric tonnes (i.e., 24 per cent).*** It is on account of this reason that the developing countries have been emphasizing in climate change negotiations in recent times that the industrialised countries should accept their 'historical responsibility' in causing environmental degradation and provide adequate compensation to the developing world for this degradation. This is known as ***'liability compensation'***. However, with much of the developed world reeling under repeated crises of public finance and sub-par economic performance, it looks unlikely that the demand for

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retrospective compensation will be taken seriously by rich industrialised countries.

Global Agenda

Recognising that visionless industrialisation and fossil fuel era had unleashed atmosphere and climate destabilising forces, delegates from fifty countries met in May 1988 to initiate steps to control this disastrous happening. This was the first International Conference on the changing atmosphere.

In June 1992, at the Earth Summit in Rio, Brazil, heads of State from 132 countries approved the Framework Convention on Climate Change. The Convention was signed by more than 160 countries. It thus provided a negotiating mechanism to arrive at an agreement among all nations as how to respond to growing climate threat. In 1994, the Intergovernmental Panel on Climate Change in its report noted that the emissions from burning of coal and oil are trapping more of the sun's heat than is normal. These serious changes in atmosphere were expected to inevitably lead to extreme high temperatures, floods and droughts in some regions.

Kyoto Protocol. In December 1997, the Climate Change Convention was held in Kyoto, Japan to decide the targets and time-schedules for reducing greenhouse gas emissions. The Kyoto Protocol provides a multilateral framework that sets limits on greenhouse emissions. Negotiated under the auspices of the UNFCCC (United Nations Framework Convention on Climate Change), it took 5 years to reach an agreement. Moreover, it took 8 years before that agreement was ratified by enough countries to become operational. USA and Australia did not ratify the treaty.

Kyoto Protocol required industrialised countries to bring down their emission to 5 per cent less than the 1990 levels by 2012 and assist the developing countries in avoiding the negative effects of climate change. Legally binding targets for 37 industrialised countries and the European Community (called the Annex I countries) for reducing greenhouse gas (GHG) emissions were set. The Kyoto Protocol came into effect in 2005. The first period of commitment under the Kyoto Protocol expired at the end of 2012. ***The second (extended) period of Kyoto Protocol is due to expire in 2020.***

Copenhagen Conference. Leaders from 192 member nations of the UN met over a 12-day period (from December 7, 2009 to December 18, 2009) at Copenhagen, Denmark, to sign a legally binding agreement setting targets and deadlines for managing emission of greenhouse gases. It was the 15th Conference (hence termed COP 15 or Conference of Parties 15) called by UNFCCC. ***The political accord arrived at in Copenhagen aims at a 2°C limit to global warming by reducing emissions 50 per cent by 2050, a global emission peaking year (without specifying the year) and $ 130 billion (₹ 6.04 lakh crore) for mitigation and adaptation by 2020, and the resolution of differences on the Kyoto Protocol and the long-term cooperative action by 2010, in the COP 16 to be held at Mexico in 2010.*** However, the Copenhagen deal was a voluntary agreement and not a legally binding agreement. Therefore, it was not likely to be taken up seriously by the developed countries who had failed to meet their commitments under the Kyoto Protocol (which was a legally binding agreement).

Cancun Climate Change Conference. The Conference of Parties (COP) 16 of the UNFCCC held over the period November 29, 2010 to December 10, 2010 at Cancun, Mexico, agreed on a ***Long-term Cooperative Action (LCA).*** In broad term, LCA is set on the principles of "common but differentiated responsibilities" of the contracting parties of UNFCCC. These principles, the most distinctive feature of the UN framework, require advanced nations to bear the burden of adjustment for ushering in a new low-carbon economy.

COP 16 also decided to establish a Green Climate Fund (GCF) to provide long-term financing to poor countries to enable them to adapt to climate impacts. It was decided that "GCF will be operating entity of the Convention's financial mechanism and will be accountable to and function under the guidance of the COP to support projects, programmes and other activities in developing countries, using thematic funding windows." It was decided that by 2020 the fund would be worth $ 100 billion annually.

Durban Climate Change Conference. The 17th Conference of Parties (COP) of the UNFCCC attended by 195 nations was held from November 28 to December 11, 2011 in Durban, South Africa. After two weeks of intense negotiations, a deal was struck and it was referred to as ***Durban Platform.*** All participating governments agreed to be a part of a ***legally binding treaty*** to address global warming. It was stated that the terms of the agreement would be defined by 2015 and it would become effective from 2020. The Conference also provided for the continuation of the Kyoto Protocol in the interim, although only some countries including members of the EU were indicated as likely to commit. In addition to this, Durban Platform led to agreement on a management framework for a future Green Climate Fund (GCF).

As critics have pointed out, the agreement arrived at in Durban effectively buried the principles of CBDR (common but differentiated responsibilities) which were enshrined in the Kyoto Protocol and all other earlier agreements as it talked of arriving at some kind of legally

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binding instrument by 2015 that would impose emission curbs on all countries from 2020. With this new legal instrument being designed to impose emission curbs on all countries, the rich countries conspired to shift the burden of combating climate change further on to the poor countries. ***Abandoning CBDR and shifting to a single legally binding agreement for all countries meant removing the differentiation between the contributors to the problem of climate change and the rest.***

Doha Climate Change Conference. The 18th Conference of Parties (COP) of the UNFCCC was held from November 26 to December 8, 2012 at Doha, Qatar. The conference made a minimal and marginal progress and it is easy to view its results as depressing. ***The only outcome of 'Doha Climate Gateway' agreed to in COP 18 that is of any real significance was the extension of Kyoto Protocol (which was due to expire at the end of 2012) by another eight years, i.e., up to 2020.*** This is known as Doha Amendment.

Another important component of the 'Doha Climate Gateway' was the decision to adopt a ***universal climate change agreement covering all countries from 2020 by the year 2015.*** This would provide the roadmap for emissions reduction in the post-2020 period. Several observers have interpreted this decision as a move to force developing countries to make binding commitments on emissions reduction.

Warsaw Climate Change Conference. The 19th Conference of Parties (COP 19) of the UNFCCC attended by 195 nations was held from November 11 to November 23, 2013 at Warsaw, Poland. Among the positives of the Conference was the creation of a mechanism for "loss and damage" under which the poorest and most vulnerable nations may get financial assistance from the rich countries on the premise that they had to suffer losses caused by high GHG emissions by the latter over the years.

In return, developing nations had to consent to a clause obliging all countries, regardless of their level of economic development to "contribute" to the global climate rescue effort through "nationally-determined" emission cuts. What this means is that ***the term "commitments" which so far applied to targeted emission reductions by developed countries alone, now stood substituted by a watered-down "contribution" to curbing climate altering greenhouse gas emissions — and applies to all.*** Also, emission reduction targets, which were hitherto determined globally through negotiations, would henceforth be fixed nationally and, therefore, voluntarily. This was a major relief for the industrialised countries, most of which, barring a few European nations, have failed to meet their targets. Apart from this, the differentiation between developed and developing countries has been diluted rather than strengthened.

Lima Climate Change Conference. The 20th Conference of Parties (COP 20) of the UNFCCC attended by 196 nations was held from December 1 to December 14, 2014 in Lima, Peru. The participating countries adopted, what has come to be known as, the ***Lima Accord.*** Under this Accord, governments were asked to submit self-determined national plans for reining in greenhouse gas emissions latest by October 1, 2015.

The plans for every country, known within the UN process as *Intended Nationally Determined Contributions (INDCs)* were to form the basis of a sweeping new deal to be signed in Paris in December 2015 (scheduled to take effect in 2020 when the extended term of Kyoto Protocol was due to expire). The word 'intended' was used because countries were communicating proposed climate actions ahead of the Paris Agreement being finalised. As governments join the Paris Agreement and start implementing their proposed climate action plans, the word 'intended' was to be dropped and an INDC would become NDC (Nationally Determined Contribution). ***The idea of a United Nations (UN) deal with obligations for all nations marks a shift from the 1997 Kyoto Protocol, which obliged only the rich countries to cut emissions.*** Moreover, even action on the new targets laid down by the nations themselves is to be voluntary without any binding obligations.

146 countries submitted their Intended Nationally Determined Contributions (INDCs) – self-determined targets for emission reductions after 2020 when the extended period of the Kyoto Protocol was due to end – by October 2, 2015. These 146 countries include all developed nations and three quarters of developing countries under the UNFCCC, covering 86 per cent of global greenhouse gas emissions. ***However, a report released by 16 major global NGOs reveals that richer countries or blocs like US and the European Union are promising much below (just about one-fifth) of their fair share of emissions. On the other hand, the INDCs of the majority of developing countries, including India, either exceed or broadly meet their fair share commitments.***

Paris Climate Agreement. The 2015 United Nations Climate Change Conference (UNCCC) COP 21 was held in Paris from November 30, 2015 to December 12, 2015. It was the 21st yearly session of the Conference of Parties (COP) to the 1992 United Nations Framework Convention on Climate Change (UNFCC). The Conference negotiated the Paris Agreement, a global agreement on reduction of climate change, the text of which represented a consensus of the representatives of the 196 nations attending it. The

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Paris Agreement took into account the INDCs submitted by different nations. Its importance stems from the fact that ***it is the second major agreement on climate change after Kyoto Protocol which was signed in 1997.*** The Paris Agreement is to apply from 2020 onwards when the extended period of the Kyoto Protocol comes to an end. The main points of the Paris Agreement were as follows:

1. The global warming target has been kept at well below 2°C with an endeavour to limit it to 1.5°C to the pre-industrial level by the end of 2100. Since temperature rise since 1850 to 2011 amounted to 0.8°C, this target *de facto* means that the earth can warm by only 0.7°C in the remaining 85 years of this century.
2. In 2018, Parties will take stock of their collective efforts against the effort needed to limit temperature rise. But the first stocktake 'under the Agreement' will be in 2023, and thereafter every five years. A 'name and shame' regime has been proposed for countries falling back on vows (i.e., on INDCs).
3. The developed countries will provide $ 100 billion a year towards climate finance (money to be given by rich nations to developing countries for adaptation and mitigation efforts) from 2020 and potentially scale it up later. However, this issue has been put in the 'decision text' and is not there in the agreement (legally binding) part of the text. Still it stipulates that the $ 100 billion will be a floor and not the ceiling as the new quantified target will need to be set up by 2025.
4. Global emissions to peak as soon as possible, probably second half of this century, without any specific time frame. ***The Agreement targets zero emissions by the end of this century.***
5. Developed countries to take economy-wise absolute emission reduction (no target) and developing countries should enhance their mitigation efforts.
6. The Paris Agreement agrees to the concept of 'Loss and Damage' through which vulnerable nations could seek financial assistance from rich nations to cover damage through instruments like insurance.

The Conference President and French Foreign Minister Laurent Fabius said that "there was something for every country to claim success" as the Agreement provided a 'unique balance' between what were major demands of the countries participating in the Conference. However, as many critics have pointed out, the target of limiting global warming to 1.5°C to pre-industrial level by the end of this century is highly ambitious and is not likely to be achieved. In fact, the aggregate of all the INDCs adds upto a minimum increase of 3°C or much more. There is no target set for developed countries to take more aggressive cuts to reduce their contributions to the growing stock of emissions in the atmosphere. ***The Paris Agreement has very little legally binding for the parties to adhere.*** All that countries are expected to do is to put out their planned emission reduction targets to the IPCC every five years. There is neither an obligation to set ambitious goals nor do they have to achieve them. Moreover, the Paris Agreement is loaded against the developing countries as the following discussion clearly brings out:

1. ***The Paris Agreement has weakened the obligation of the rich nations to fight climate change as there is no reference in it to the 'historical responsibility' of these countries.*** This principle recognised that global warming has been caused by greenhouse gas emissions since 1850 and those which have contributed to the earth's crisis are responsible for making amends. Now, thanks to considerable pressure by the US to ensure that every country is to be treated at par, the carbon debt of the past 165 years has been wiped off. The principle of historical responsibility was inserted in the UN Framework Convention on Climate Change in Rio de Janeiro in 1992, largely at India's insistence. Instead, countries will now be examined by their 'respective capabilities and national circumstances', which concedes differentiation but does not put the onus on industrial countries, as climate justice demands.[32]
2. The carbon budget, which should have been at the core of a climate agreement, does not even get a mention. As pointed out by Sunita Narain, of the 2900 billion tonnes of carbon dioxide that the world can emit if it wants to stay below 2°C, some 1900 billion tonnes have already been used up – this amount of carbon dioxide has already accumulated in the atmosphere. There are some 1000 billion tonnes left, which can be emitted between now and 2100. The already industrialized countries have 'overused' their carbon quota. Their lacklustre INDCs reveal their intentions to occupy more of global carbon space in future as well. In fact, by 2030, according to the current emission targets on the table, some 80 per cent of the carbon budget will be used up. In other words, ***what is available to the world to use up to 2100 will be nearly finished by 2030.*** This would be fine if all countries were at equal levels of development and would not require any space for growth beyond

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2030. But this is hardly the case. Many developing countries including India, even under the most aggressive plans for growth, would still be struggling to meet the basic needs of people beyond 2030. But by then, the carbon budget would be appropriated and gone. What happens to their right of development? asks Sunita Narain. As correctly pointed out by her, if temperature increase is capped at 1.5°C, then the carbon budget would be limited even further. If the world is to cap temperature rise at 1.5°C, then the remaining budget shrinks to a mere 450-500 billion tonnes. At the current rate of emissions, the budget will be more or less exhausted by 2020. So, what happens to the right of development of the developing countries, including India? If this is not injustice, what is?[33]

3. Nothing much has been achieved on the issue of climate funding as well. The $ 100 billion a year financing of GCF by 2020 by developed countries is not a part of legally binding commitments but forms a part of the decision text. Thus, the entire financing is to be 'open-ended', with no obligations on any country.
4. While commitments to reduce emissions and to pay developing countries to adapt to climate change are not compulsory in the Agreement, the procedures for review and reporting of the INDCs are. The review will take place every five years from 2023 and has caused considerable discomfiture among developing countries like India as ***there is a fear of interference by developed countries in their economic policies***.
5. The issue of 'loss and damage' (financial help extended to vulnerable countries hit by disasters) has been considerably watered down as the Agreement does away with any liability for compensation. It establishes a mechanism to address financial losses from climate impacts. But claims of liability or compensation are not permissible.

As the above discussion shows, the Paris Agreement is heavily loaded against the developing countries. What it does is to universalise action to reduce emissions, without apportioning the responsibilities or rights of countries for creating the problem or reducing emissions. Thus, Paris Agreement cements ***climate apartheid.*** It has absolved the developed countries of their 'historical responsibility' on the one hand, and passed on the burden of future transition to the developing countries on the other hand.[34]

Impact on India. The Paris Agreement is not likely to have any immediate impact on India as it was able to get some differentiation in all elements of the Agreement. However, it may not remain so in the next 5-10 years when rich world will try to create another layer of advanced developing countries like India and China and pressurize them to undertake more responsibilities for cutting down emissions. India will also have to improve the quality and frequency of its emission data inventory as it will come under global scrutiny under the 'name and shame regime' for its rising emissions. The International Monetary Fund estimates that India would figure in the world's top five economies and become the third largest emitter by 2025, when the next level of enhanced climate action plans (INDCs) come into force. Most experts say that by then, India will have to announce an estimated deadline for plateauing its carbon emissions – which means no more use of coal, the country's primary energy source. This could pose serious challenges as India depends on coal for more than two-thirds of its energy requirements and can ill-afford to do away with it. The Government of India in its INDCs has pledged to produce two-fifths of its electricity from renewable sources by 2030. The government's goals, both on coal and renewable energy, are far more ambitious than what the demand scenario looks like. As far as GCF is concerned, India is not likely to get much from it. In fact, if India becomes one of the five largest economies in the world by 2025 as predicted by IMF, it may have to donate to GCF.

Marrakech Climate Change Conference. The Paris Agreement defined parties' basic obligations and established new procedures and mechanisms. But for these to be fully operational, their details must be further elaborated. This requires the adoption by parties of an extensive set of decisions known loosely as the 'Paris rulebook'. This 'rulebook' covers a wide range of topics, including mitigation, adaptation, finance, transparency, a new 'global stocktake' process, market mechanisms, and implementation and compliance. Contours of the 'rulebook' pertaining to many of these issues were laid down in Marrakech Conference which was held in Marrakech, Morocco, from November 7, 2016 to November 18, 2016 (also known as COP 22).

Bonn Climate Change Conference. The 2017 United Nations Climate Change Conference (UNFCCC) COP 23 was held at Bonn in Germany from November 6 to November 17, 2017 (the political host of COP was Fiji though the summit was held in Bonn with the support of the German government). The Conference was marked by modest accomplishments and the most thorny issues were left to be tackled by the COP 24 to be held in Poland towards the end of 2018. The Conference once again brought to the fore the 'North-South divide' with the developed countries on the one side and the developing countries on the other. ***Although the USA had withdrawn from the Paris Agreement, it***

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actively connived with the other developed countries to block the aspirations of the developing countries to achieve a fair deal. This was not unexpected as in the past also, despite the fact that it had not signed the Kyoto Protocol, it played a crucial part in shaping the policy due to its continuing membership of the UNFCCC. Thus, although it did not accept any binding commitment on serious climate action (as was required under the Kyoto Protocol), USA has continued to call the shots. The other developed countries have also coordinated their policy and actions closely with it, even if there have been some differences in rhetoric gives the very different domestic pressures that operate in various countries. According to T. Jayaraman, the developed countries' agenda over the years has focused on: (*i*) denying, undermining and eventually setting aside differentiation; (*ii*) pushing the burden of climate mitigation on the large developing countries or developing regions, especially those that are in the ranks of the 'emerging economies'; (*iii*) keeping their emission reduction commitments to a minimum, relying on future offsets under some global carbon market mechanism; (*iv*) putting up a strong stand to limit the claims to climate finance by the developing countries; and (*v*) eventually relying on markets and the private sector to take care of climate action.[35]

The main issues that need to be highlighted in an assessment of the negotiations that took place under COP 23 are as follows:

1. Pre-2020 commitments. The first issue of contention between the developed countries and the developing countries was on the reluctance of the former to honour their commitments made for the period upto 2020 under the extended (second) period of the Kyoto Protocol. These commitments are separate to the Paris Agreement, which applies only post-2020. In this respect, there were two main concerns: (*i*) the developed countries had not yet delivered the promised $100 billion per year in climate finance by 2020 agreed in 2009 at Copenhagen; and (*ii*) the Doha Amendment, a second commitment period of the Kyoto Protocol for the years leading upto 2020, had still not been ratified by enough countries to bring it into force.

2. Fights over finance. The developed countries have neither honoured their pre-2020 commitments on finance nor the promise to ramp up climate finance to the figure of $100 billion is anywhere near being adequately addressed. Therefore, there was considerable 'fight' over the issue of finance during the closing days of the summit. The developing countries dug in their heels and were successful in obtaining a procedural guarantee that the subject would remain on the agenda and the outcome of the discussions at the intersessional meetings would be reported back to COP in December 2018.

3. Paris 'rulebook'. As was the case at COP 22 in Marrakech, negotiations in COP 23 centred around attempts to make significant progress on developing the Paris 'rulebook'. This will establish the more technical rules and processes needed to fulfil the Paris Agreement's ambition.

These discussions are overseen by the Ad-hoc Working Group on the Paris Agreement, or APA. Its work covers several areas, including setting the framework of NDCs, reporting of adaptation efforts, the transparent reporting of action taken at a 'global stocktake' in 2023, and how to monitor compliance with the Paris Agreement. The deadline for this work is COP 24 to be held in December 2018. But the goal in Bonn was to create a draft of these implementation guidelines, with options and disagreements outlined as clearly as possible to show what still needs resolving.

4. Loss and damage. There was no success on this front in COP 23 despite the fact that an island nation, Fiji, greatly vulnerable to the impact of climate change, was in the Presidency. There was no commitment of any concrete 'action and support' from the developed countries. In fact, as pointed out by T. Jayaraman, "even in purely procedural terms, the discussions on loss and damage are not even guaranteed to be a permanent part of the agenda of future COP meetings".[36]

5. Privatising climate action? A matter of serious concern is the significant message from Bonn that a comprehensive attempt to rewrite the terms of global climate governance is underway. This new trend is the emphasis on 'non-State' actors in climate negotiations. The non-State actors include the likes of global and domestic corporations, philanthropy-funded international non-governmental organisations (NGOs) and their domestic counterparts, and fragmented local actors. Increasing importance to non-State actors in future negotiations will devalue the negotiations and the role of nation-States considerably. Moreover, the non-State actors will divert the public debate and the course of public action in a manner conducive to their own self-interests. Significantly, the commitments made by such actors have no legal standing and there is no way that they can be held accountable except in purely moral terms.[37]

6. Talanoa dialogue. Countries agreed in Paris Agreement that there should be one-off moment in 2018 to 'take stock' of how climate action was progressing. This information will be used to inform the next round of NDCs, due in 2020. Originally called the 'facilitative dialogue', the name of this one-process in 2018 was changed to 'Talanoa dialogue' in Bonn under the Fiji Presidency. This was to reflect a traditional approach to discussions in Fiji for an 'inclusive, participatory and transparent' process ('Talanoa' is a Fijian world for traditional form of negotiations). Talanao

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dialogue started in January 2018 is structured on three questions – "Where are we? Where do we want to go? How do we get there?" – but also includes new details, such as a decision to accept inputs from non-party stakeholders as well as parties, a decision to set up an online platform to receive inputs, and a new emphasis on efforts being made in the pre-2020 period.

7. COP 24: COP 24 was held in December 2018 at Katowice, Poland. New research released at the COP showed global emissions were going up, not down. This Conference failed on many fronts as difficulties in the approaches of developed and developing countries persisted. However, it was agreed that all countries will have to report their emissions – and progress in cutting them – every two years from 2024.

Despite settling on large parts of the Paris rulebook, countries failed to agree on the rules for voluntary market mechanisms, pushing part of the process onto next year for COP 25 to be held in Chile in 2019.

With US walking out of the Paris Agreement and the known scorn of its President for global cooperation on environmental issues, all future global negotiations seem to be in jeopardy. However, it is time to realise the importance of common global action on the climate front. As pointed out by Sunita Narain, "The challenge of climate change is a make-or-break situation for the world. It forces us, perhaps for the very first time in our history, to realise that we live together on one earth. It tells us that there are limits to growth, and more importantly, that growth will have to be shared among all. Ultimately, we cannot share a vision for how the world will combat climate change unless we are prepared to share the common atmospheric resources of the world. The big question is whether we will prove to be up to the challenge. ***The answer is that we have no choice".***[38]

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10 Chapter HUMAN RESOURCE DEVELOPMENT: EDUCATION AND HEALTH

Many statistical investigations carried out in the Western countries have shown that output increased at a much higher rate than can be explained by an increase in physical inputs like labour and physical capital. The reason is that the quality of human beings as a productive source has been consistently improving due to improvement in education and skills, availability of health services, etc. Therefore, ***side by side with physical capital formation, human resource development has also been playing a useful role in economic development.*** The earlier economists also recognised this role of human resources and explicitly included human beings, or their acquired abilities and skills, as a component of capital. Most of these economists held that human beings should be regarded as a resource for production purposes for three reasons: "(1) the cost of rearing and educating human beings is a real cost; (2) the product of their labour adds to the national wealth; (3) an expenditure on a human being that increases this product will, *ceteris paribus,* increase national wealth."[1]

Theodore W. Schultz has argued that ***investment in education enhances human capital formation.*** If this is not done and production is carried out with the help of unskilled and uneducated labour, the production will fall catastrophically from its existing level.[2]

In this chapter, our analysis of human resources addresses the following issues:

- What is the role of human resource development in the growth process and economic development?
- How does education contribute to human resource development?
- How is the education policy of the government relevant to development of human resources in the country?
- What is the state of health facilities in India and how do they sustain the human resource development?
- National Health Policy, 2017 and National Health Protection Scheme (announced in Union Budget 2018-19)

IMPORTANCE OF HUMAN RESOURCE DEVELOPMENT

Human resource development plays an important role in economic development. In fact, effective use of physical capital itself is dependent upon human resources. This is due to the reason that if there is underinvestment in human resources the rate at which additional physical capital can be productively utilised will be limited since technical, professional and administrative people are required to make effective use of material resources. Modern economists in recent decades have pointed out that many Third World countries have remained underdeveloped on account of underdevelopment of human resources. For instance, the general masses in these countries are either illiterate or their level of education is very low, most of them are unskilled and untrained, and their general health is very poor. Therefore, large-scale investments in human resources are needed if physical capital available in these countries is to be exploited more fully and in a more efficient way. It has also been observed that the development of human resources is intricately related to the process of economic development. Both proceed together and reinforce one another.

Education and Human Resource Development

Education and skill training result in human resource development in the following manner:

1. Education and economic growth. As noted above, ***investments in education promote economic growth.*** Various studies have been conducted by economists in the West to assess the contribution of education in economic growth. According to Todaro and Smith, education contributes to economic growth in the developed and developing countries in the following ways:

(1) It helps in creating a more productive labour force and endowing it with increased knowledge and skills; (2) it helps in providing widespread employment and income-earning opportunities for teachers, school, and construction workers, textbook and paper printers, school uniform manufacturers, etc.; (3) it helps in creating a class of educated leaders to fill vacancies left by departing expatriates or otherwise vacant positions in governmental services, public

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corporations, private businesses, and professions; and (4) it helps in providing basic skills and encourages modern attitudes in the diverse segments of the population.[3]

2. Education and reduction in income inequalities. Though the linkages between education and economic growth are very much in evidence in both, developed and developing countries, those between education and reduction in income inequalities (and poverty) are difficult to establish. Most of the Third World countries have launched upon programmes of universal education in the hope that they will improve the human capabilities of the poor people and enable them to increase their family earnings. In short, ***education is seen as a great egalitarian measure which would help in improving the human resources in general on the one hand and on the other would enable the less privileged and poor classes of people to improve their economic lot.***

3. Education and rural development. Education can contribute significantly to rural development in a variety of ways. ***By widening the horizons of knowledge of the rural people, it can enable them to overcome ignorance and superstitions. Adoption of new agricultural techniques and new methods of production is rendered easier if the farmers are educated.*** Education can be oriented as to impart skills and attitudes useful in improving the quality of family life (for example, through education on subjects such as health and nutrition, home repairs and improvements, family planning and child care, etc.). In labour surplus economies like India, education can help rural people in acquiring skills to set up cottage industries on their own so that the disguisedly unemployed people can be fruitfully employed in the villages themselves.

4. Education and family planning. Education helps in modernising and revolutionising the ways of thinking of the people. It enlightens them of the need to improve their standards of living and, for this purpose, to restrict the size of their families. Therefore, ***education serves as the best method of family planning in the long-run.*** Also, as more and more women get education and seek employment, the fertility rates show a tendency to decline because upbringing of children is a comparatively difficult task for working women.

5. Other benefits of education. In addition to the benefits discussed above, education confers a number of other benefits on the society. A long, but nevertheless incomplete, list would be as follows: (1) the current spillover income gains to persons other than those who have received extra education; (2) the spillover income gains to subsequent generations from a better educated present generation; (3) the supply of a convenient mechanism for discovering and cultivating potential talents; (4) the meeting of the skilled manpower requirements of growing economy; (5) the provision of an environment that stimulates research in science and technology; (6) the tendency to encourage lawful behaviour and to promote voluntary responsibility for welfare activities; (7) the tendency to foster political stability by developing an informed electorate and competent political leadership; (8) the supply of a certain measure of 'social control' by the transmission of a common cultural heritage; and (9) the enhancement of the enjoyment of leisure by widening the intellectual horizons of both the educated and the uneducated.[4]

6. Role of on-the-job training. As stated earlier, ***productivity of physical capital is substantially enhanced if an improvement in human capital is effected. It is on account of this reason that many firms in India provide on-the-job training to their workers.*** Such training has the advantage that it can be provided fast and without much cost. Also, on-the-job training can be tailored to the learning capabilities and peculiarities of the individuals working on particular machines. Such training increases the skill and efficiency of the workers and leads to an increase in production and productivity.

Role of Health in Improving the Quality of Human Capital

Improvement in the health of masses increases their productive capacity and leads to qualitative improvement in human capital. Therefore, expenditures on health are important in building and maintaining a productive labour force as well as in improving the lives of the people and the quality of society. Basically, expenditures on health take the form of investment in medical knowledge, in disease prevention and in treatment and rehabilitation. Because a large number of poor living below subsistence levels in underdeveloped countries suffer from malnutrition, the health care programmes in these countries can be taken to include all steps aimed at improving the level of nutrition of these people. In a narrow sense, programmes included under health care are as follows: (1) expanding medical knowledge through increased basic research in the life sciences; (2) faster dissemination of new information and techniques to help policymakers and the public; (3) more and better organised health facilities and manpower, including research laboratories and medical schools, general hospitals and nursing homes, highly trained specialists and nursing aids; (4) improved financing of medical services; and (5) free medical aid to the poor and downtrodden and other poor sections of the population.

Measuring the Contribution of Human Capital Formation to Economic Development

Since all those activities that increase man's productive capacity are included under human capital formation, we can see that it is practically impossible to measure its

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contribution to economic development. Most of the attempts in this field have been directed at measuring the contribution of education to economic growth (though some attempts have also been made to measure the contribution of health to economic growth). Even here, we are not on sure ground since, as noted earlier, the list of benefits accruing from education is very large and most of these benefits are 'non-quantifiable'. To measure the contribution of education in economic development, the principal approaches adopted are the following: (1) determination of the relationship between expenditures on education and growth in income or in physical capital formation over a period of time in one country; (2) the residual approach in determining the contribution of education to gross national product (GNP); (3) calculation of the rate of return from expenditures on education; and (4) making intercountry correlations of school enrolment ratios and GNP.

EDUCATION IN INDIA AND DEVELOPMENT OF HUMAN RESOURCES

In India, expenditure on education is not considered as an investment in human resources, yet in Government Plans, which were meant for promoting economic growth, education finds a place. However, the proportion of public expenditure on education to GDP in India had stagnated for three decades since early 1950s. The proportion of public expenditure on education to GDP started increasing around the mid-1980s and there has also been some improvement in the share of elementary education,[5] together with some reduction of inter-State disparities.[6] However, even now public expenditure on education in India is most inadequate. It was only 3.1 per cent of GDP in 2015-16[7] (much less than the goal of 6 per cent of GDP).

Literacy. According to the 2011 Census, national average literacy rate is 73 per cent as against 18.33 per cent in 1951. In isolation this may look quite impressive, but the fact remains that even after more than sixty years of planned development in the country, 26.0 per cent (*i.e.*, more than one-fourth) of the population remained illiterate in 2011. In eleven States literacy rates are lower than the national literacy rates. These States are Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Jammu and Kashmir, Jharkhand, Madhya Pradesh, Odisha, Rajasthan and Uttar Pradesh. In Bihar, literacy rate was as low as 63.82 per cent in 2011. ***Kerala had the highest literacy rate of 93.91 per cent.*** In this State, even the female literacy rate was as high as 91.98 per cent as against the national female literacy rate of 65.46 per cent (which shows that ***in 2011, at national level, more than one-third females were illiterate***). Rajasthan, Bihar, Uttar Pradesh, Jammu and Kashmir, and Jharkhand are the States where female literacy rates are appallingly low. Bihar in 2011 had a female literacy rate as low as 52.66 per cent.

In terms of literacy, India's attainments as compared to several Asian countries are rather disappointing. According to *World Development Indicators* 2017, adult literacy rate for males in India during the period 2007-16 was only 79 per cent while it was 93 per cent in Sri Lanka, 96 per cent in Philippines and 97 per cent in China. Situation is still worse if one compares adult literacy rate for females. For instance, adult literacy rate for females in India during 2007-16 was only 59 per cent while it was 90 per cent in Sri Lanka, 93 per cent in China and 97 per cent in Philippines.

EDUCATION POLICY IN INDIA

National Education Policy, 1968

For twenty years after Independence no change was made by the Nationalist government in the colonial education policy of the British rulers. In 1964 the government realised that a change was needed in the educational system. Thus, an Education Commission under the chairmanship of Professor D.S. Kothari was constituted, which submitted its report to the government in 1966. ***The government on the basis of the recommendations made by the Education Commission announced its National Education Policy in 1968.*** The following are the important features of this policy: (1) All children up to the age of fourteen should get compulsory education. Due to widespread poverty in the country, elementary education should be free. (2) To improve the standard of education, the condition of teachers should be improved and particular attention should be given to their salary scale. (3) In order to meet the requirements of agriculture and industry, curriculums at different levels should be modified. (4) Due recognition should be given to the work done in specialised institutes of scientific research. (5) In order to bring uniformity in the character and standard of education in all the States, a fifteen years educational system should be introduced. This system of education is quite often called as 10+2+3 system. (6) For national integration, study of three languages was recommended. English and Hindi were considered necessary for all students and, in addition to these two languages, a student was expected to study one of the regional languages.

National Policy on Education, 1986 and 1992

In August 1985, the government provided a policy perspective and hoped to formulate its new education policy in the light of the debate generated by it. The National Policy on Education (NPE) was announced in 1986. It envisaged universalisation of primary education and adult literacy by 1990. It accorded a high priority to the qualitative improvement

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of education, especially technical and higher education, vocationalisation of secondary education, development of regional languages, strengthening of monitoring and evaluation machinery for effective implementation of plan programmes, etc. The New Education Policy also stressed the importance of dynamic and beneficial linkages between education, health, social welfare and employment programmes. NPE was revised in 1992. The modified policy envisages a National System of Education to bring about uniformity in education, making adult education programmes a mass movement, providing universal access, retention and quality in elementary education, special emphasis on education of girls, establishment of pace-setting schools like Navodaya Vidyalayas in each district, vocationalisation of secondary education, starting more Open Universities in the States, strengthening of the All-India Council of Technical Education (AICTE), encouraging sports, physical education, etc.

The National System of Education as envisaged in the NPE is based on a national curricular framework, which envisages a common core along with other flexible and region specific components. While the policy stresses widening of opportunities for the people, it calls for consolidation of the existing system of higher and technical education. It also emphasises the need for a much higher level of investment in education of at least 6 per cent of the national income. The highest advisory body to advise the Central and State governments in the field of education is the Central Advisory Board of Education (CABE) reconstituted in 2004.

Right of Children to Free and Compulsory Education Act, 2009 (RTE Act)

The Constitution (86th Amendment) Act, 2002 inserted Article 21A in the Constitution which provides for free and compulsory education of all children in the age group of 6-14 years as a Fundamental Right in such a manner as the State may, by law, determine. In order to put in place a suitable legislation as envisaged under Article 21A, ***The Right of Children to Free and Compulsory Education (RTE) Act, 2009 was passed by the Parliament on August 4, 2009.*** The RTE Act was notified on August 27, 2009 for general information and the notification for enforcing the provisions of the Act with effect from April 1, 2010 was issued on February 10, 2010. Salient features of the RTE Act are as follows: (1) Every child of the age 6-14 years shall have a right to free and compulsory education in a neighbourhood school till completion of elementary education; (2) The appropriate government and the local authority shall establish, within such area or limits of neighbourhood, a school where it is not so established, within a period of three years; (3) The Central and State governments shall have concurrent responsibility for providing funds for carrying out the provisions of the Act; (4) It shall be the duty of every parent or guardian to admit or cause to be admitted his or her child or ward to an elementary education in the neighbourhood school; (5) No school or person shall, while admitting a child, collect any capitation fee and subject the child or his or her parent or guardian to any screening procedure; (6) No teacher shall engage himself or herself in private tuition or private teaching activity; and (7) The Central government shall constitute by notification a National Advisory Council, consisting of members to be appointed from amongst persons having knowledge and practical experience in the field of elementary education and child development for advising the Central government on implementation of the Act in an effective manner.

Elementary and Secondary Education Schemes

1. Sarva Shiksha Abhiyan (SSA). Launched in 2001, Sarva Shiksha Abhiyan (SSA) is one of India's major flagship programmes for universalisation of elementary education. Its overall goals include universal access and retention, bridging of gender and social category gaps in elementary education, and achieving significant enhancement in learning levels of children. SSA is being implemented in partnership with the State governments and reaches out to 192 million children in 1.1 million habitations across the country. Goals of SSA are as follows: (*i*) enrolment of all children in school, Education Guarantee Centres or Alternative Schools; (*ii*) retention of all children till the upper primary stage; (*iii*) bridging of gender and social category gaps in enrolment, retention and learning; and (*iv*) ensuring that there is significant enhancement in the learning achievement levels of children at the primary and upper primary stage. Provisions of Right to Education Act are being implemented through SSA. Accordingly, norms have been revised/modified to align them with the requirement of RTE Act, 2009.

Progress in achieving the goal of universal access under SSA/RTE 2009 Act has been consistent over the years. There were 1,73,757 habitations unserved by primary schools in 2001-02 when SSA was launched. Over the years, 2,04,686 primary schools were sanctioned of which 347 were sanctioned in 2014-15. At the upper primary stage, there were 2,30,941 habitations unserved by upper primary schools in 2002. Over the years 1,59,427 upper primary schools have been sanctioned in a radius of 3 kms, including 248 sanctioned in 2014-15. Under SSA, India has not only been able to improve access to 99 per cent of primary level but has also been able to reduce out-of-school children to 3-4 per cent of the age cohort of 6-14 years. Under this programme, special focus is on girls, children belonging to SC/ST communities, other weaker sections, minorities and urban deprived children. To bring out-of-

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school children into the fold of elementary education, Education Guarantee Scheme (EGS), Alternative Innovative Education (AIE) and Bridge Course Strategies have been adopted.

2. Padhe Bharat – Badhe Bharat. Another major initiative of the Government of India is a nationwide sub-programme under SSA called 'Padhe Bharat – Badhe Bharat'. Launched in 2014, this programme has been planned in a twin track approach: (1) to improve language development by creating an enduring interest in reading and writing with comprehension; and (2) to create a natural and positive interest in mathematics related to the physical and social world. The two tracks of Padhe Bharat – Badhe Bharat are – Early Reading and Writing with Comprehension (ERWC) and Early Mathematics (EM) particularly in class I and II. The objectives of this programme are: to enable children to become independent, and engaged readers and writers; with comprehension possessing sustainable and lasting reading and writing skills and achieve learning levels appropriate to the class of study; to make the children understand the reasoning in the domains of number, measurement and shapes; and enable them to become independent in problem solving by way of numeracy and spatial understanding skills and to associate reading, writing and early mathematics with the experience of joy and real-life situation. An amount of ₹ 397 crore was approved for Padhe Bharat – Badhe Bharat for 2014-15.

3. Rashtriya Madhyamik Shiksha Abhiyan (RMSA). A new centrally sponsored scheme, the RMSA, to enhance access to secondary education and improve its quality was launched in March 2009. The objectives of the scheme are to achieve an enrolment ratio of 75 per cent (from 52.26 per cent in 2005-06) for Classes IX-X within five years by providing a secondary school within reasonable distance of every habitation, to improve quality of education imparted at secondary level through making all secondary schools conform to prescribed norms, to remove gender, socio-economic and disability barriers, universal access to secondary level education by 2017, *i.e.,* by the end of Twelfth Five Year Plan and universal retention by 2020.

4. National Programme of Mid-day Meals in Schools.[8] With a view to enhancing enrolment, retention and attendance and simultaneously improving nutritional levels among children, the MDM (mid-day meals) programme was launched as a centrally sponsored scheme on August 15, 1995, initially in 2,408 blocks of the country. By the year 1997-98 it was introduced in all blocks of the country. It was further extended in 2002 to cover not only children in Classes I-V of government, government aided and local body schools, but also children studying in EGS and AIE centres. At present, it covers all children studying in Classes I-VIII in government, government-aided, local body, NCLP (National Child Labour Project), EGS and AIE centres including madarasas and maqtabs supported under SSA.

The programme provides a mid-day meal of 450 calories and 12 grams of protein to children at the primary stage. For children at the upper primary stage, the nutritional value is fixed at 700 calories and 20 grams of protein. Adequate quantities of micronutrients like iron, folic acid and vitamin-A are also recommended under the programme. To meet the nutritional norm, the Central government provides foodgrains at the rate of 100 grams per primary school child/school day and 150 grams per upper primary school child/school day. MDM programme has helped in promoting school participation, preventing classroom hunger, instilling educational values and fostering social and gender equality.

5. Kasturba Gandhi Balika Vidyalaya (KGBV). The KGBV scheme was launched in July 2004 for setting up residential schools at upper primary level for girls belonging predominantly to the SC, ST, OBC and minority communities. This scheme targets areas of scattered habitations.

The scheme provides for minimum reservation of 75 per cent seats for girls from SC/ST/OBC and minority communities, and 25 per cent to girls from families that are below the poverty line.

6. National Programme for Education of Girls at Elementary Level (NPEGEL). NPEGEL scheme is a holistic effort to address obstacles to girls' education at the micro level through flexible, decentralised processes and decision-making. It is being implemented in educationally backward blocks (EBB) and addresses the needs of girls who are 'in' as well as 'out' of school. It also reaches out to girls who are enrolled in school, but do not attend school regularly. NPEGEL provides for setting up of a 'model school' in every cluster with more intense community mobilisation and supervisions of girls' enrolment in schools. Gender sensitisation of teachers, development of gender-sensitive learning materials, and provision of need-based incentives like escorts, stationery, workbooks and uniforms are some of the endeavours under the programme.

7. Udaan. The number of girls joining the IITs is really low when compared to the total enrollment in technical education. Merely 10-12 per cent of girls are able to clear the entrance to these premier technical educational institutions. In order to promote educational opportunities for girl students, CBSE has launched the Udaan programme (giving wings to girl students), designed to provide a comprehensive platform to deserving girl students who aspire to pursue higher education in engineering, and assist them to prepare for the IIT/JEE while studying in classes XI and XII. ***The project aims at addressing the lower enrollment of girls in engineering colleges.*** Therefore, it is envisaged as the first step towards achieving this larger goal of

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addressing the quality gap between school education and engineering entrance, by addressing the three dimensions of education – curriculum design, transaction and assessment.

The aim is also to enrich and enhance teaching and learning of science and mathematics at the senior secondary level. The objective of this project is to provide a platform that empowers the girl students and provides better learning opportunities to them. As a result, they will be able to compete confidently at the entrance examinations in the technical education institutions and eventually become important stakeholders in the technical growth of the nation.

Annual Status of Education Report

The Annual Status of Education Report (ASER) facilitated by PRATHAM, a non-governmental organisation (NGO), is conducted in every rural district of India by volunteers from a local organisation in the district – these are colleges and universities, NGOs, youth groups, women's organisations and others. The first report was published in 2005. Till 2017 (i.e., till the eleventh report), the focus was on elementary, primary and upper primary education. Over the years, the ASER has observed a clear rise in enrolment. For example, in the 6-14 age group, the enrolment increased from 93.4 per cent in 2005 to 96.4 per cent in 2016. However, what is a serious cause of concern is the fact that ***the quality of learning – as measured by reading, writing and arithmetic – has either shown no improvement or has actually worsened over the years.*** For example, the proportion of all children in Class 5 who can read a Class 2 level text has declined from 61.3 per cent in 2005 to 47.8 per cent in 2016. This means that every other student is unable to read something meant for someone three classes below. The children fared no better in Mathematics or English comprehension. For example, the ability of Class 8 students to divide numbers has further declined. The proportion of all Class 8 students in rural areas who can divide a three-digit number by a single-digit one has dipped to 43.2 per cent in 2016 from 44.2 per cent in 2014. And while 32 per cent of children in Class 3 could read simple English words in 2016, up by 3.5 percentage points over 2009, in Class 5, only one out of every four students could read an English sentence. ASER 2016 underlines that this situation has remained unchanged since 2009, when the Right to Education, or RTE, Act was passed by Parliament. The focus of the government has been on providing and extending infrastructure. This has led to larger numbers of children transitioning to the upper stage and beyond. However, as is clear from the data given above, there has been an almost total neglect of 'learning outcomes'. This has resulted in a situation where ***a hundred million children have gone through the schools in the last decade without basic reading and math skills.*** Moreover, the neglect of learning outcomes has contributed significantly to a growing divide in every village and community between those who access private schools or tutors, and those who do not.

ASER 2017. ASER 2017 released on January 16, 2018 surveyed students in the age group of 14-18 years (i.e., secondary and senior secondary school students) for the first time. The results of the Report are quite disturbing as is clear from the following facts: (*i*) 57 per cent of the 14-18 year olds (i.e., over one in two students) could not do a simple division; (*ii*) 47 per cent (i.e., nearly one out of two) 14-year olds could not read a simple sentence of English (the proportion was two out of five for 18-years olds); (*iii*) 25 per cent in the 14-18 age group could not read basic text even in their own language; and (*iv*) the proportion of students who have not acquired basic mathematical skills by age 14 is the same as that of an 18-year old (i.e., there is no improvement in basic mathematical skills). Some other findings of ASER study are equally disappointing. For example, 24 per cent (i.e., one-fourth) in the 14-18 age group could not count currency correctly, 44 per cent could not add weights correctly in kilograms as they were asked to add weights, 14 per cent could not recognise a map of India and some 36 per cent could not name the capital of India. Similarly, while 79 per cent could name the State they lived in, 58 per cent could not locate it on a map.[9] ***Since the youth in the 14-18 age group are ready to enter the workforce, their 'learning deficit' and 'lack of skills' is likely to have an adverse effect on India's competitiveness in the world economy in times to come.*** Moreover, what advantage can India have from its so-called demographic dividend if this is the quality of education the secondary school students are receiving? In fact, such poorly educated and low skilled youth cannot be easily absorbed in the workforce and the number of unemployed youth is only likely to swell in the near future.

Higher and Technical Education

The Indian higher education system, which includes Technical Education, is one of the largest in the world, just after United States and China. Higher education is the most powerful tool to build a knowledge-based society for the future. While at the time of Independence, there were only 20 universities and 500 colleges with 0.1 million students, their number increased to 799 universities and university level institutions and 39,071 colleges in 2015-16. The number of management institutions in this year stood at 435. In addition to setting up new institutions in the field of higher and technical education during the period of planning, many other initiatives have also been undertaken in this field. These include the upgradation of State engineering institutions, expansion of research fellowships and provision of hostels for girls, reservation for SCs, STs and OBCs,

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focus on backward, hilly and remote locations including the North-East, facilitating greater participation of students belonging to minorities, girls and persons with disabilities, scholarships, provision of educational loans with interest free subsidies, setting up of polytechnics in unserved areas, and degree colleges in low GER (Gross Enrolment Ratio) districts. It is undoubtedly true that because of all these initiatives, the enrolment of students in institutions of higher education has increased considerably over the years. However, ***the lower penetration into higher levels of education leads to higher dropouts, especially among the secondary and upper primary students, consequently to accumulation of less educated and less skilled job seekers at the bottom of the pyramid.*** The percentage educated also falls progressively with higher levels of education.[10]

Problems of India's Education System

The education system in India suffers from a number of problems and faces a number of challenges. The country's mean years of schooling at 5.12 years is well below the other emerging market economies such as China (8.17 years) and Brazil (7.54 years) and significantly below the average for all developing countries (7.09 years). An idea about the problems facing India's education system can be had from the following discussion:

1. According to *India Human Development Report* 2011, despite considerable improvement in the literacy status, ***India is home to the largest number of illiterate people in the world, accounting for about one-third of all illiterates.*** Since the dropout rates at the primary level remain high, the number of illiterate (or almost illiterate) could be rising. This is because children who do not complete a minimum of five years of schooling are unlikely to retain literacy or numeracy skills in their adulthood. The problem of illiteracy is more acute in rural areas, particularly among rural females, 43 per cent of whom were illiterate in 2007-08.[11]

2. According to IHDS (India Human Development Survey), 2010, ***percentages of failures and dropouts is very high.*** As noted by the Report, the poor quality of schooling remains a major cause of concern. The fact that 46 per cent of 8-11 year children cannot read a simple three sentence paragraph does not augur well for the future of the civic society. Arithmetic skills are even poorer.

3. ***The quality of Indian schools is abysmal.*** Many schools, particularly in the countryside, exist without teachers. Overcrowded classrooms, a crumbling infrastructure, lack of teaching aids, dull teaching methods, poor pupil achievements, etc., all result in a ***'discouragement effect'***[12] – children tend to dropout of school, and, at the same time, parents also lose their enthusiasm in sending their children to schools. Under these circumstances, education has failed to make any significant improvement in the life of most people in the countryside.

4. ***Regional disparities in a variety of educational indicators are striking.*** While States like Himachal Pradesh have made rapid strides, Bihar, Rajasthan, Chhattisgarh and Madhya Pradesh remain far behind. These inequalities can be seen even in basic skills such as literacy, but the differences are vast when we consider advanced skills, such as knowledge of English or computer usage. Moreover, inequalities between women from different States are greater than those between men. According to IHDS, "this digital divide may lead to widening income differences between regions in the years to come and deserves greater attention than hitherto accorded".[13]

5. In addition to regional disparities, ***there are significant educational inequalities between different social and economic strata*** and these are visible in school enrolment, type of schooling, educational expenditures, and school performance. According to IHDS, "Children from Dalit, Adivasi, and Muslim families, and to a lesser extent those from OBCs, face unique disadvantages. Much of the policy focus has been directed at positive discrimination via reservations in college admissions, but we find that this is too little and too late in students' educational careers. ***Many disadvantages begin as early as primary school."***[14]

6. ***The number of out-of-school children who are physically or mentally challenged remains a cause for concern.*** The proportion of disabled out-of-school children in 2005 was 34.19 per cent and remained unchanged at 34.12 per cent in 2009. It is important to note that the maximum number of out-of-school children are those with mental disabilities (48 per cent) followed by children with speech disabilities (37 per cent). As pointed out by the Twelfth Plan, "neither the school system nor any other institutional mechanism is equipped to address the challenging needs of mentally disabled children who are most disadvantaged both socially and educationally in the system".[15]

7. Secondary and senior secondary education serves as a bridge between elementary and higher education. It also forms the basis of skill formation in future. However, ***the spread of secondary education in India is quite limited.*** It is true that the GER at secondary level (includes Class XII) has increased from 56.8 per cent in 2011-12 to 65.3 per cent in 2014-15. However, GER at senior secondary level (Class XI-XII) is considerably less than at the secondary level (Class IX-X). According to the Twelfth Plan, "The significant dip in GERs from secondary to senior secondary level for all categories is driven by a number of factors including general lack of access, paucity of public schools, high cost of private senior secondary education, alongwith the very important factor of high opportunity cost of deferred entry into the workforce".[16]

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8. The annual average drop-out rates in States like Odisha is as high as 30 per cent which requires policy interventions. Similarly, the retention rates in secondary schools is less than 50 per cent in Bihar, Rajasthan, Tripura, Manipur, Mizoram, Madhya Pradesh, Assam, Meghalaya, Arunachal Pradesh, Jharkhand and Nagaland. At the all-India level, the retention rate is 57 per cent. All these facts are a cause of worry and suggest the need to improve the delivery of the schemes/programmes.

9. ***The higher education system at present suffers from several weaknesses,*** such as proliferation of substandard institutions, deterioration of academic standards, outdated curriculum, failure to maintain academic calendar and lack of adequate support for research. Moreover, there are wide disparities between rural and urban areas.

10. ***At present in the area of technical education, various imbalances and distortions exist.*** Over the years quantitative expansion of technical education has lowered the standards and now there is a structural imbalance in skill requirement of the business sector and the traditional curriculum followed by the engineering and management institutions. The infrastructural facilities available in most of these institutions are inadequate and yet there has been enormous increase in public expenditure on technical education.

11. According to the 71st report of the NSSO (January 2014 to June 2014), ***the costs of education have increased considerably over the years***. The costs of education have been increasing for both general and technical/professional education across all levels. The average annual private expenditure on general education per student (primary and above) has increased from ₹ 2,461 in 2007-08 to ₹ 6,788 per student in 2014-15. The average expenditure on education varies depending on the type of institution, course, level, etc. The differences in expenditure become starker in the case of professional/technical education. The average expenditure on technical/professional education in private aided and unaided institutions was 1.5 to 2.5 times that in government institutions. In addition to the rising costs of education in private institutions, private coaching has also emerged as a major component of educational expenditure other than course fees. The share of private coaching in the educational expenditure is around 30 per cent in secondary levels in rural areas and around 45 per cent in higher secondary levels in urban areas among the students attending government institutions.[17]

Suggestions for Improving the Education System

If education has to raise the quality of human resources, the following changes will have to be made in the existing educational system:

First of all, restrictions should be introduced on higher education. The essential conditions for University education should be laid down and only those who satisfy them should be admitted to postgraduate courses. Most of the research work done in Indian Universities is unproductive and the expenditure involved is a colossal waste. For making research both meaningful and productive, emphasis should be on quality and not on quantity. ***Secondly,*** education should be made job-oriented. In other words, emphasis should be on vocational education rather than on general education. ***Thirdly***, education in science is costly and its expansion should be carefully planned. There is no point in producing science graduates if they can get only clerical jobs. For these jobs, commerce and arts graduates will not be less competent while the expenditure on their education will be much smaller. ***Fourthly***, in rural areas emphasis should be on agriculture and vocational education. General education has been found less useful in these areas. In certain cases it has proved to be disastrous. For instance, rural people after getting some education lose interest in agriculture and migrate to cities in search of employment where very few jobs exist for them. ***Fifthly***, technical education should be properly planned. Since it involves heavy cost, the government must ensure jobs to all the technical hands. Further, if a person getting technical education at the State's expense wants to go abroad, the government must claim the money which it has spent on his education from him. ***Sixthly***, efforts should be made to improve the standards of education at higher secondary and university levels. ***Finally***, the government must investigate the reasons for the large number of dropouts and should make attempts to solve this problem. In this respect, it is necessary to overcome the 'discouragement effect' about which we have written above. Overcoming this effect depends crucially on improving the accessibility, affordability and quality of schooling in India. According to Dreze and Sen, ***much can be done without delay in this field like opening more schools, improving the infrastructure, appointing more teachers, simplifying the curriculum, organising enrolment drives, providing free textbooks etc. However, the primary challenge would be to improve the teaching standards in the classroom.***[18]

HEALTH POLICY

Efficiency of workers depends considerably on their health. Workers whose health is not good and who fall sick quite often, cannot do their job efficiently and thus their efficiency is bound to remain low. Improvement in the health of workers automatically raises the national output. *World Development Report 1993* stated, ***"Improved health contributes to economic growth in four ways: It reduces***

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production losses caused by worker illness, it permits the use of natural resources that had been totally or nearly inaccessible because of disease, it increases the enrolment of children in schools and makes them better able to learn, and it frees for alternative uses resources that would otherwise have to be spent on treating illness. The economic gains are relatively greater for poor people, who are typically most handicapped by ill-health and who stand to gain the most from the development of underutilised natural resources."[19]

Two things are necessary for good health: (*i*) Balanced and nutritious diet, and (*ii*) Medical care.

Poor Health of an Average Indian

The general health standard in India is quite low. ***This is clearly reflected in the high incidence of morbidity in the country.*** The main reasons for this are lack of nutritious diet, inadequate medical care and living under unhygienic conditions. All these factors, in turn, are related to the poverty of the people. People, who do not even get two square meals a day, cannot dream of a balanced and nutritious diet. They cannot afford even medical care since it has become very costly. Hospitals which are located in urban areas are not within the reach of most of the rural population. Therefore, ***the basic cause of poor health of mass of the population in this country is widespread poverty.***

Health Policy in India

The Government of India prepared its programme for raising the health standard in the country, on the basis of recommendations made by the Health Survey and Development Committee (More Committee 1946) and the Health Survey and Planning Committee (Mudaliar Committee 1961). The objectives of this programme were spelt out as follows: (*i*) provision should be made for the control of epidemics, (*ii*) health services should be provided in such a form that in addition to the control of various diseases, care of patients also becomes possible, and (*iii*) programmes for the training of employees in the Health Department should be speeded up and the primary health centres should be developed in the rural sector for improving medical facilities in the countryside.

Under the Fifth Five Year Plan, health development programmes were integrated with family welfare and nutrition programmes for vulnerable groups — children, pregnant women and nursing mothers. The accent of the schemes during the period was on increasing health services in rural areas, intensification of the control of communicable diseases, such as smallpox, malaria and leprosy, improvement in education and training of health personnel and specialists, attention to common diseases in rural areas, etc. The achievements during the planning period, however, fell short of the target.

The main objective under the Sixth Plan was to provide better health care and medical care services to the poor people, including those living in the rural areas. A community based programme of health care and medical care services in rural areas was also launched.

Under the Seventh Plan, a new health scheme was implemented. The objective of this scheme was to provide medical facilities to the relatively neglected sections of the society. During the Eighth Plan, hospital facilities were sought to be strengthened and hospital beds in urban areas increased. The bulk of the resources available for this programme were, however, to be utilised for conversion of primary health centres into rural hospitals or strengthening the facilities in existing hospitals located in the rural areas. During the Ninth and Tenth Plans, efforts were further intensified to improve the health status of the population by optimising coverage and quality of care by rectifying the critical gaps in infrastructure, manpower, equipment, essential diagnostic reagents and drugs. Efforts were also directed to improve the functional efficiency of the health care system. ***The National Health Policy, 2002 and the Common Minimum Programme (CMP) of the UPA government stressed the need for achieving an acceptable standard of good health amongst the general population of the country.*** With focus on primary health care, the CMP envisaged raising public expenditure on health to at least 2-3 per cent of GDP. The Eleventh Plan proposed the adoption of a comprehensive approach that encompasses individual health care, public health, sanitation, clean drinking water, access to food, and knowledge of hygiene, and feeding practices. The Plan also set seven measurable targets, reflecting the health status to be achieved by the end of the Plan period. While the target for public expenditure on health was kept at 2-3 per cent of GDP, the actual achievement at the end of the Plan was only 1.04 per cent of GDP. Eleventh Plan expenditure on health was ₹ 89,576 crore. The Twelfth Plan outlay on health was kept at ₹ 3,00,018 crore. The objective was to increase the total expenditure on core health from 1.04 per cent of GDP in 2011-12 to 1.87 per cent of GDP by the end of the Twelfth Plan (2016-17). Twelfth Plan laid down the following ***'national goals'*** in the health sector: *(i)* Reduction of Infant Mortality Rate (IMR) to 25; *(ii)* Reduction of Maternal Mortality Rate (MMR) to 100; *(iii)* Reduction of Total Fertility Rate (TFR) to 2.1; *(iv)* Prevention and reduction of undernutrition in children under 3 years to half of NFHS-3 (National Family Health Survey-3) (*i.e.*, 2005-06) levels; *(v)* Prevention and reduction of anaemia among women aged 15-49 years to 28 per cent; *(vi)* Raising child sex ratio in the 0-6 year age-group from 914 to 950; *(vii)* Prevention and reduction of burden of communicable and non-communicable diseases (including

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mental illnesses) and injuries; and *(viii)* Reduction of poor households' out-of-pocket expenditure.[20]

Major Health Programmes

1. National Health Mission (NHM). The NHM was launched in 2013 to enable universal access to equitable, affordable, and quality health care facilities. It subsumes the NRHM (National Rural Health Mission) which was launched in April 2005 and National Urban Health Mission (NUHM) which was initiated in 2013. Provision of accessible, affordable, accountable, effective and reliable primary health care facilities, especially to the poor and vulnerable sections of the population, bridging the gap in Rural Health Care services through creation of a cadre of Accredited Social Health Activists (ASHA), improved health care, decentralised planning, ensuring population stabilization, intersectoral convergence and maintaining gender balance constitute the basic features of the NRHM. The NUHM which was initiated in 2013 is aimed to cover all cities/towns with a population of more than 50,000 and all district headquarters with a population above 30,000. Other towns would continue to be covered under NRHM.

More than 8.96 lakh ASHAs are in place across the country and serve as facilitators, mobilizers and providers of community level care. ASHA is the first point of call in the community especially for marginalised sections of the population, with a focus on women and children. Since 2013, when the NUHM was launched, ASHAs are being selected in urban areas as well. ASHA has been a key figure in contributing to the positive outcomes of increases in institutional delivery, immunization, active role in disease control programmes (malaria, kala-azar and lymphatic filariasis, in particular) and improved breastfeeding and nutrition practices.

The NRHM has many achievements to its credit. The increased patient flow at PHCs and CHCs (community health centres) and improved institutional deliveries and immunisation are an indication of the Mission's positive impact on health care delivery. However, the programme suffers from a number of weaknesses like: *(i)* inadequate number of PHCs and CHCs, *(ii)* absence of basic facilities (proper buildings, hygienic environment, electricity and water supply, etc.) in many existing health centres, *(iii)* shortage of service providers at different levels (particularly doctors and nurses in many health centres), *(iv)* acute shortage of essential drugs, contraceptives and vaccines at many PHCs and CHCs, *(v)* quick response MMUs, meant to take medical care to the patient's doorstep in far-flung areas, have not been operationalised in many States even though substantial funds have been released for the purpose, etc.

2. Janani Suraksha Yojana (JSY). Janani Suraksha Yojana is a safe motherhood intervention under the NRHM being implemented with the objective of reducing maternal and neo-natal mortality by promoting institutional delivery amongst the poor pregnant women. ***JSY is a 100 per cent centrally sponsored scheme and it integrates cash assistance with delivery and post-delivery care.*** The scheme focuses on the poor pregnant women with special dispensation for having low institutional delivery rates. The JSY scheme has shown rapid progress during the last few years. The increase in institutional deliveries, coupled with improvement in infrastructure, manpower and training has resulted in significant improvement of institutional deliveries in all major States.

3. Pradhan Mantri Swasthya Suraksha Yojana (PMSSY). The PMSSY was launched with the objective of correcting regional imbalances in the availability of affordable/reliable tertiary health care services and to augment facilities for quality medical education in the country. These are sought to be achieved through establishing AIIMS (All-India Institute of Medical Sciences) like institutions and upgrading existing medical college institutions. The upgradation programmes broadly envisage improving health infrastructure through construction of super speciality blocks/ trauma centres, etc., and procurement of medical equipment for existing as well as new facilities.

4. Swachh Bharat Mission (Gramin). Launched on October 2, 2014, this programme aims at attaining an Open Defecation Free India by October 2, 2019, by providing access to toilet facilities to all rural households and initiating Solid and Liquid Waste Management activities in all Gram Panchayats to promote cleanliness. Under SBM(G), the incentives for Individual House Hold Latrines (IHHLs) have been enhanced from ₹ 10,000 to ₹ 12,000 to provide for water availability. Initiatives by the government in this regard include media campaigns, provisioning for incentivising ASHAs and Anganwadi workers for promoting sanitation, guidelines to involve Corporates in sanitation sector through CSR (Corporate Social Responsibility), and strengthening online monitoring system for entering household level data gathered from the Baseline Survey.

5. Other Programmes. Other important programmes include the Revised National Tuberculosis Control Programme (RNTCP), National Vector Borne Disease Control Programme (NVBDCP), National Programme for Control of Blindness (NPCB) and National Leprosy Eradication Programme (NLEP). NVBDCP is being implemented for prevention and control of vector borne diseases like malaria, filariasis, Kala-azar, Japanese encephalitis (JE), dengue and chikungunya. Most of these diseases are epidemic prone and have seasonal fluctuations. RNTCP using Directly Observed Treatment Short-course (DOTS) is being implemented with the objective of curing

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at least 85 per cent of the new sputum positive patients initiated on treatment, and detecting at least 70 per cent of such cases. NPCB was launched in the year 1976 as a 100 per cent centrally sponsored scheme with the goal to reduce the prevalence of blindness to 0.3 per cent by 2020. The National Leprosy Control Programme was launched by the Government of India in 1955. It was renamed as the National Leprosy Eradication Programme (NLEP) in 1983. Subsequent to the introduction of NRHM, Leprosy programme has also been an essential part of the Mission.

Expansion of Health Care Facilities: A Critical Evaluation

The quantitative measurement of the improvement in the health of an average Indian is not possible, nonetheless there should not be any doubt about some improvement in the general health of a large number of people in the country. ***During the planning period, the death rate has considerably declined and it was 6.4 per thousand in 2016 as against 27.4 per thousand in 1951. The infant mortality rate has also come down from 146 per thousand in 1951 to 34 per thousand in 2016. Moreover, life expectancy at birth has risen from 37.2 years for males and 36.2 years for females in 1951 to 66.9 years for males and 70 years for females during 2011-15.***

There is no denying the fact that progress in improving health outcomes has been slow. As a result, India continues to face an extraordinarily high disease burden, which saps the productivity of Indian workers and lowers their earnings. According to a 2010 World Bank estimate, India loses 6 per cent of its GDP annually because of premature deaths and preventable illnesses. The main weaknesses of the Indian health care system are as follows:

1. Public health expenditure in India has moved up over the past decade, but still remains among the lowest in the world – it was merely 1.4 per cent of GDP in 2015 *vis-a-vis* 3.0 per cent in China, 4.3 per cent in South Africa and 4.7 per cent in Brazil.

2. India's public health expenditure is not only low, it is also regressive. Only 17.3 per cent of lower income classes (defined as the bottom three deciles) benefit from the public health system as against 22 per cent of higher income classes (defined as the seventh, eighth and ninth deciles).[21]

3. ***Availability of health care services from the public and private sectors taken together is inadequate.*** This is starkly evident from the data on doctors and nurses per lakh of population. At the start of the Eleventh Plan, the number of doctors per lakh of population was only 45, whereas the desirable number is 85 per lakh population. Similarly, the number of nurses and auxiliary nurses and midwifes available was only 75 per lakh population whereas the desirable number is 225. The overall shortage is exacerbated by a wide geographical variation in availability across the country. Rural areas are especially poorly served.

4. ***Quality of health care services varies considerably in both the public sector and the private sector.*** Many practitioners in the private sector are actually not qualified doctors. A WHO report published in 2016 noted that only one in five doctors in rural India is qualified to practice medicine. The report said that 31.4 per cent of those calling themselves allopathic doctors were educated only upto Class 12 and 57.3 per cent doctors did not have a medical qualification.[22]

5. While due to various facilities and concessions granted by successive governments in recent period, there has been a massive expansion of the private health sector, ***no regulatory mechanism has been established to oversee malpractices.*** There is a virtual absence of regulation of almost everything that happens – standards, quality, costs, etc. The private establishments are often unethical, greedy, treating medical services as a business and hospitalisation as a source of profit. Although the private health players have been provided land at ridiculously low rates to build hospitals (at ₹ 5,000 an acre in Delhi and a virtually absurd ₹ 1 for 15 acres to a joint venture with the Delhi government), they have failed to meet their obligation to provide free medical treatment to an agreed proportion of patients from the economically weaker sections. In addition, as noted by Shailaja Chandra, the Indian citizens (rich or poor) have no protection against medical exploitation or malpractice. Regulators like the Medical Council of India and the State Medical Councils rarely react to medical malpractice. The Consumer Protection Act 1986 deals with the failure of service contracts – the focus being on compensation and not medical malpractice which is the crying need.[23] Public sector doctors are not covered even by such controls.

6. ***Affordability of health care is a serious problem for the vast majority of the population.*** The lack of extensive and adequately funded public health services pushes large number of people to incur heavy out-of-pocket expenditures on services purchased from the private sector. In fact, India has emerged as the country with the largest out-of-pocket expenditure on health, among the BRICs countries consistently higher at more than 60 per cent since 2008 (it was 62.4 per cent in India in 2014 while it was only 25.5 per cent in Brazil, 32.0 per cent in China and 6.5 per cent in South Africa). As correctly pointed out by *Economic Survey* 2016-17, the higher out-of-pocket expenditure on health leads to the impoverishment of poorer sections of society and widens inequalities. Out-of-pocket expenditure for poor is a double whammy because, one, adverse health conditions

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impact their productivity and ability to earn their daily incomes, and second, payments to get themselves treated adds to their 'financial distress' and impoverishes them.[24] For example, it has been estimated that each year 63 million people close to the population of the United Kingdom, are pushed into poverty because of catastrophic health expenditure. They are forced to abandon jobs because of ill health or have to sell their land assets to pay health care costs.

7. India is undergoing a major epidemiological transition in consonance with social and economic development. Contribution of communicable diseases to deaths in India fell from 53.6 per cent in 1990 to 27.5 per cent in 2016, while that of Non Communicable Diseases (NCDs) rose from 37.9 per cent to 61.8 per cent over the same period.[25] As a result, health care costs increased as NCDs typically require expensive treatment. According to the Twelfth Plan, "In the years ahead, India will have to cope with health problems reflecting the dual burden of disease, that is, dealing with the rising cost of managing NCDs and injuries while still battling communicable diseases that still remain a major public health challenge, both in terms of mortality and disability."[26]

8. The total expenditure on health care in India, taking both public, private and household out-of-pocket expenditure was about 4.7 per cent of GDP in 2014, which is broadly comparable to other developing countries, at similar levels of per capita income. However, ***the public expenditure on health was only 30 per cent of the total in 2014, which is very low by any standard.*** Contrast this with the fact that public expenditure accounts for 70 per cent to 85 per cent of total expenditure in most countries of the European Union and North America. The world average in 2014 was 60.1 per cent and even the averages for Sub-Saharan Africa (42.6 per cent) and for the 'low income countries' in the world (42.4 per cent) were also much higher than India's. As noted by Dreze and Sen, only a few countries (like Afghanistan, Haiti and Sierra Leonne) have a lower ratio of public health expenditure to total health expenditure as compared with India. According to Dreze and Sen, ***"the unusual reliance on private health care in India results largely from the fact that the country's public health facilities are very limited, and quite often very badly run".***[27]

9. The state of child health care in India is abysmal. According to the *State of the World's Children Report 2016* published by UNICEF, around 1.2 million under-five children died of preventable causes in India in 2015. Most of the deaths were caused by diseases easily preventable and treatable. According to the Report, India is among the five countries accounting for half the 5.9 million under-five deaths reported across the world in 2015.

10. There are major differences regarding various health indicators in different States. ***MMR, IMR and TFR continue to be quite high in relatively backward States*** like Uttar Pradesh, Bihar, Orissa, Rajasthan and Madhya Pradesh. It is also a disturbing fact that in many States, child sex-ratio (0-6 years) has witnessed a decline in the 2001-11 decade.

11. ***Health workers are paid very low wages*** with the result that they do not have enough 'motivation'. For instance, there are cases where ASHA workers are paid a meagre ₹ 350 per institutional delivery. They do the work of a primary health worker without a regular salary.

NATIONAL HEALTH POLICY 2017

The government approved the National Health Policy (NHP) 2017 on March 15, 2017.[28] The Policy seeks to reach everyone in a comprehensive integrated way to move towards wellness. It aims at achieving universal health coverage and delivering quality health care services to all at affordable cost.

Objectives of NHP, 2017

The main objectives of NHP, 2017 are as follows:

1. Assuring availability of free, comprehensive primary health care services, for all aspects of reproductive, maternal, child and adolescent health and for the most prevalent communicable, non-communicable and occupational diseases in the population.

2. Ensuring improved access and affordability, of quality secondary and tertiary care services through a combination of public hospitals and well measured strategic purchasing of services in health care deficit areas, from private care providers.

3. Achieving a significant reduction in out-of-pocket expenditure due to health care cost.

4. Influence the operation and growth of the private health care sector and medical technologies to ensure alignment with public health goals.

5. Increasing health expenditure by the government as a percentage of GDP from the existing 1.15 per cent to 2.5 per cent by 2025.

6. Achieving the following quantitative targets, among others: (*i*) increase life expectancy at birth from 67.5 years to 70 years by 2025; (*ii*) reduction of TFR (total fertility rate) to 2.1 at national and sub-national level by 2025; (*iii*) reduce under five mortality to 23 by 2025 and MMR (maternal mortality ratio) from current levels to 100 by 2020; (*iv*) reduce infant mortality rate to 28 by 2019; (*v*) increase utilisation of public health facilities by 50 per cent from current levels by 2025; (*vi*) ensure that more than

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90 per cent of the newborn are fully immunised by one year of age by 2025; (*vii*) reduction of 40 per cent in prevalence of stunting under-five children by 2025; and (*viii*) access to safe water and sanitation to all by 2020 (Swachh Bharat Mission).

Policy Thrust

NHP 2017 has envisioned health and wellness centres as the foundation of India's health system. These 1.5 lakh centres are expected to bring health care system closer to the homes of the people. They are expected to provide comprehensive health care including for NCDs and maternal and child health services. They are also expected to provide free essential drugs and diagnostic services. ***The government has committed ₹ 1,200 crore in the Union Budget 2018-19 for this flagship programme.*** It has also invited contribution of private sector through CSR (Corporate Social Responsibility) and philanthropic institutions in adopting these centres. The main thrust areas under NHP 2017 are as follows:

1. Ensuring adequate investment in the health care sector (with this end in view, NHP 2017 proposes a potentially achievable target of raising public health expenditure to 2.5 per cent of GDP in a time-bound manner).

2. Ensuring coordinated action on the following seven priority areas for improving the environment of health: (*i*) the Swachh Bharat Abhiyan; (*ii*) Yatri Suraksha (preventing deaths due to rail and road traffic accidents); (*iii*) Nirbhaya Nari (action against gender violence); (*iv*) balanced, healthy diet, and regular exercises; (*v*) addressing tobacco, alcohol and substance abuse; (*vi*) reduced stress and improved safety in the workplace; and (*vii*) reducing indoor and outdoor pollution.

3. Introducing policy shifts in organising: (*i*) primary care, (*ii*) secondary and tertiary care, (*iii*) infrastructure and human resource development, (*iv*) public hospitals, (*v*) urban health, (*vi*) National Health Programmes, and (*vii*) AYUSH (Ayurveda, Yoga and naturopathy, Unani, Siddha and Homoeopathy) services. For instance, in primary care, the intention is to move from 'selective care to assured comprehensive care with linkages to referral hospitals' while in the case of public hospitals, the intention is to move from 'user fees and cost recovery to assured free drugs, diagnostic and emergency services to all.'

National Health Programmes

NHP, 2017, emphasises renewed focus on the following national health programmes: (*i*) programmes supporting maternal and child survival, (*ii*) programmes aimed at achieving optimum levels of child and adolescent health (by pre-empting the occurrence of diseases), (*iii*) interventions to address malnutrition and micronutrient deficiencies, (*iv*) universal immunisation, (*v*) tackling communicable diseases, (*vi*) control of tuberculosis, (*vii*) control of HIV/AIDS, (*viii*) leprosy elimination, (*ix*) vector borne disease control, (*x*) halting and reversing non-communicable diseases like diabetes, hypertension, cancer, blindness, deafness, etc., (*xi*) programmes aimed at strengthening mental health services, and (*xii*) population stabilisation.

Medical Education

NHP, 2017, recommends strengthening of existing medical colleges and converting district hospitals to new medical colleges to increase the number of doctors and specialists, in States with large human resource deficit. It also recognises the need to increase the number of post graduate seats and supports expanding the number of AIIMS like centres or continuous flow of faculty for medical colleges, biomedical and clinical research. NHP, 2017, also proposes a number of measures for attracting and retaining doctors in rural and remote areas. Various steps are also advocated for developing a cadre of mid-level care providers (through appropriate courses like a B.Sc. in community health), expanding the cadre of AYUSH doctors, providing more facilities for nursing education, certification programme for ASHAs, etc.

Many social activists in recent times have advocated that just as RTE (Right to Education), health also should be made a fundamental right. However, NHP, 2017, considers that the time has not yet arrived to make health a fundamental right as the required infrastructure to make this possible is not in place. Moreover, health care is linked to many issues like poverty, equity, sanitation, nutrition, drinking water availability, etc. which extend beyond the health care and, are difficult to manage.[29]

NATIONAL HEALTH PROTECTION SCHEME (UNION BUDGET 2018-19)

The Finance Minister announced in the Union Budget 2018-19 that the government will launch a flagship National Health Protection Mission (NHPM) ***"to cover over 10 crore poor and vulnerable families (approximately 50 crore beneficiaries) providing coverage upto ₹ 5 lakh per family per year for secondary and tertiary care hospitalisation".*** Dubbed as ***Modicare*** (on lines of Obamacare – a health care plan launched by Barack Obama when he was the President of USA), this is labelled as the world's largest health insurance scheme.

NHPM under Ayushman Bharat initiative was approved by the Cabinet on March 21, 2018. The scheme is estimated to cost ₹ 12,000 crore per year. The main features of NHPM are as follows:

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1. It aims to provide cover to nearly 40 per cent of the population or 10.74 crore poor and vulnerable households (50 crore people) with the premium paid by the government.

2. Each family will be entitled to a health cover of ₹ 5 lakh a year.

3. Coverage will be based on the Socio Economic Caste Census (SECC), which identifies poor in seven defined categories of deprivation.

4. The beneficiaries can avail benefits in both public and empanelled private facilities.

5. All the pre-existing conditions will be covered from day one of the policy, all major surgeries or treatments such as cancer, heart surgeries will be covered except a few such as organ transplants.

6. Specific QR codes will be given to families entitled for the scheme. QR code is a machine-readable optical label that will contain information about the families and their members. These codes will be sent to the beneficiaries' addresses.

7. In partnership with NITI Aayog, a modular, scalable and interoperable IT platform will be made operational, which will entail paperless and cashless transactions.

8. NHPM will subsume the ongoing centrally sponsored schemes Rashtriya Swasthya Bima Yojana which offers a cover of ₹ 30,000 per annum and the Senior Citizen Health Insurance Scheme, which offers cover upto ₹ 30,000 per annum.

Given the fact that in-patient hospitalization expenditure has increased nearly 300 per cent in the last ten years and that more than 60 per cent of the total expenditure under health care is out-of-pocket expenditure, the NHPM is an important initiative. NHPM is essentially a health insurance scheme. Given the fact that the business of health insurance is yet to make a meaningful breakthrough in the country (gross health insurance was only 0.18 per cent of GDP in 2015-16), NHPM is a welcome step towards achieving inclusive health care. However, it must not be forgotten that there are three tiers in the Indian health care system. Primary health care is provided through PHCs in rural areas and family welfare centres in urban areas. Secondary health care involves referral from primary health care centres and such care is generally provided in district hospitals and community health centres at the block level. Tertiary health care is basically specialised consultative care provided in advanced medical research colleges and institutes, based on referrals from either primary or secondary care centres. NHPM aims to cover both secondary and tertiary health care. Its effectiveness will depend considerably on the health infrastructure at the PHC level which, as noted earlier, is in a bad shape. As pointed out by J. Dennis Rajakumar, ***"any initiatives to redress the health care system in the country should begin from PHCs that suffer from sheer neglect."***

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12 Chapter

EMPLOYMENT AND UNEMPLOYMENT IN INDIA

The size of employment in a country depends to a great extent on the level of development. Therefore, when a country makes progress and its production expands, the employment opportunities grow. In India, production has expanded in all the sectors of the economy over the years. In response to these developments the absolute level of employment has also grown. However, unemployment in absolute terms has also increased. This has happened because jobs in adequate number were not created. In fact, while the country witnessed impressive rates of economic growth during many years in the economic reforms period (i.e., the post-1991 period), rate of growth of employment lagged considerably behind with the result that unemployment has increased significantly. This phenomenon is often referred to as the phenomenon of 'jobless growth'. In some years, there was also 'job loss' growth.

In this chapter while analysing the employment and unemployment trends, we shall address the following issues:

- Employment trends
- Structure of employment
- Nature and estimates of unemployment
- Unemployment in urban areas
- Unemployment in rural areas
- Causes of unemployment
- Government policy for removing unemployment
- Major employment programmes
- Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS)
- Rethinking the employment strategy: Focus on manufacturing
- Appendix I to Chapter 12: National Policy for Skill Development and Entrepreneurship 2015
- Appendix II to Chapter 12: Pradhan Mantri Kaushal Vikas Yojana (PMKVY)
- Appendix III to Chapter 12: Deen Dayal Upadhayaya – Grameen Kaushal Yojana

EMPLOYMENT TRENDS

In the recent past, there has been deceleration in the growth of employment in India in spite of the accelerated economic growth. For example, when GDP grew at 4.7 per cent per annum during 1972-73 to 1983, employment growth was 2.4 per cent; GDP growth increased to 5 per cent, but employment growth declined to 2.0 per cent during 1983/1993-94; during 1993-94/2004-05, GDP growth accelerated to 6.3 per cent, but employment growth further declined to 1.8 per cent; and during the period 2004-05/2011-12, when GDP growth was as high as 8.5 per cent, employment grew at an insignificant rate of 0.5 per cent. This can be explained in terms of a steady decline in employment elasticity in all major sectors of economic activity except in construction. ***Overall employment elasticity (ratio of employment growth to growth in value added) which was 0.52 during 1972-73 to 1983, declined to 0.41 in the next 10-year period and further to 0.29 during 1993-94 to 2004-05. During 2004-05 to 2011-12, it declined to just 0.04 (i.e., almost zero).*** Employment elasticity in agriculture, in fact, which was 0.46 during 1972-73 to 1983 fell quite fast and turned negative (–0.42) during 2004-05 to 2011-12.[1]

Details on employment trends are available from various Rounds of the NSSO — the 55th Round provided estimates for 1999-2000, the 61st Round for 2004-05, the 66th Round for 2009-10 and 68th Round for 2011-12. Information on employment trends for the period 1993-94 to 2011-12 is presented in Table 12.1. Before presenting an analysis of this information, it is necessary to understand the difference between labour force and workforce as defined by the NSSO. The Survey is based on a sample. Depending on the reply to the survey questions, the sample is bifurcated into two categories, *i.e.,* those in the 'labour force' and those 'not in the labour force'. ***The first category consists of those who are seeking work.*** This is essentially the category that either finds employment or remains unemployed. ***Those who find employment are designated as the 'workforce' by the NSSO and those who are unable to find employment are designated as 'unemployed'.*** As noted by C. Rangarajan, Padma Iyer

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Kaul and Seema, "Since the 'labour force' is the total of which the 'workforce' is a part, any changes in the former are bound to have an impact on the latter."[2] The second category, *i.e.*, 'not in the labour force' consists of persons who are not seeking work. This withdrawal from the labour force could be on account of pursuit of education, sickness, domestic work, disability, etc.

Important results that are obtained from Table 12.1 are as follows:

As can be calculated from Table 12.1, the labour force increased by 25 million over the period 1993-94 to 1999-2000 and by 62 million over the period 1999-2000 to 2004-05. However, the labour force increased by only 3.6 million over the next five year period 2004-05 to 2009-10. The two year period 2009-10 to 2011-12 recorded an increase of as much as 11.43 million people in the labour force. As against the labour force of 381.94 million in 1993-94, workforce was 374.45 million which implies that the number of unemployed people was 7.49 million. As a ratio of labour force, this works out at 2.0 which therefore was the unemployment rate in 1993-94. The number of unemployed rose to 8.97 million in 1999-2000 and 11.17 million in 2004-05. As a result, the unemployment rate also rose to 2.2 per cent in 1999-2000 and further to 2.4 per cent in 2004-05. The situation improved somewhat over the period 2004-05 to 2009-10 with the number of unemployed people declining to 9.84 million and the unemployment rate to 2.1 per cent. However, it can be calculated from the data on workforce given in Table 12.1 that ***while 23 million jobs were created during the period 1993-94 to 1999-2000 and as many as 60 million during five year period 1999-2000 to 2004-05, only 5 million jobs could be created over the five year period 2004-05 to 2009-10.*** Given against the fact that the country had witnessed a robust economic growth during the period 2004-05 to 2009-10, this represents a dismal performance on the employment front. In fact, as is clear from the Table, the CAGR of the workforce declined from 2.83 per cent during the period 1999-2000 to 2004-05 to just 0.21 per cent during the period 2004-05 to 2009-10. However, the data for 2011-12 based on 68th Round of NSSO presents an encouraging picture. As can be calculated from Table 12.1, ***over the two year period 2009-10 to 2011-12, around 11 million jobs were created*** (as against only 5 million jobs during the earlier five year period). There was a significant improvement in the CAGR of the labour force and workforce between 2009-10 and 2011-12 as compared to between 2004-05 and 2009-10. Both the labour force and workforce grew at a rate of around 1.2 per cent per annum from 2009-10 to 2011-12 as compared to a low rate of around 0.1 to 0.2 per cent per annum from 2004-05 to 2009-10. However, as noted by Rangarajan, Seema and Vibeesh, this is still way behind the growth rate of around 3 per cent per annum observed between 1999-2000 and 2004-05.[3]

Withdrawal of Rural Females. Some observers have recently pointed to the fact of the withdrawal of rural females from the total labour force in recent times. For example, C. Rangarajan, Seema and E.M. Vibeesh have pointed out that while rural female LFPR (labour force participation rate) hovered around 33 per cent for most of the period spanning 1977-78 to 2004-05, it came down significantly to 26 per cent from 2004-05 to 2009-10 and further to 25 per cent between 2009-10 to 2011-12. They provide two 'plausible reasons' for the withdrawal of rural women from the labour force on such a large scale:

1. In recent years, women's participation in education has increased tremendously. The number of girls enrolled in secondary and senior secondary education increased from 16 million to 23 million between 2005-06, and 2010-11 and more than doubled in higher education from 5.5 million to

Table 12.1

Employment and Unemployment (by UPSS)

	1993-94	*1999-2000*	*2004-05*	*2009-10*	*2011-12*	*1993-94 to 1999-2000*	*1999-2000 to 2004-05*	*2004-05 to 2009-10*	*2009-10 to 2011-12*
	in million					*CAGR %*			
Labour force	381.94	406.85	468.73	472.32	483.75	1.06	2.87	0.15	1.20
Workforce	374.45	397.88	457.56	462.49	472.91	1.02	2.83	0.21	1.12
Unemployed	7.49	8.97	11.17	9.84	10.84				
As a proportion of labour force in per cent									
Unemployment rate	2.0	2.2	2.4	2.1	2.2				

Notes: 1. All figures pertain to UPSS, *i.e.*, usual principal and subsidiary status.
2. CAGR is compound annual growth rate.

Source: C. Rangarajan, Seema and E.M. Vibeesh, "Developments in the Workforce between 2009-10 and 2011-12", *Economic and Political Weekly*, June 7, 2014, Table 2, p. 118.

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12 million during the same period. So, the first reason for the fall in the female labour force can be partly explained by the ***'education effect' – a larger number of rural females are opting for education rather than joining the labour force.*** NSSO data also show the same trend in education. In 1999-2000, around 18 per cent of rural women were opting for education; this percentage increased to 25 per cent in 2011-12. In the younger age groups of 5-24 years, the increase is sharper and the share reached 63 per cent in 2011-12 from 43 per cent in 1999-2000.

2. Another important factor is the ***'income effect'*** due to rising rural incomes. If we take per capita household expenditure as a proxy for the income level, the latest two Rounds of NSSO clearly show a sharp increase of around 3 per cent per annum in the real per capita consumption expenditure between 2004-05 and 2011-12 as compared to only 0.2 per cent per annum between 1999-2000 and 2004-05. "With the rise in the level of income in rural India, rural females engaged in casual work/unpaid work in agriculture are, perhaps, withdrawing from the labour force and getting engaged in the domestic activities."[4]

STRUCTURE OF EMPLOYMENT

The structure of employment can be followed by examining the sectoral distribution of employment, employment in organised sector, and rural and urban employment.

Sectoral Distribution of Employment

In Table 12.2, we have provided estimates of employment by sectors. These estimates are based on NSS data for the various Rounds.

The main results that can be obtained from a study of Table 12.2 are as follows:

1. The main sector as far as employment is concerned, continues to be agriculture although there has been a decline in employment in this sector in percentage terms (from 73.9 per cent in 1972-73 to 64.8 per cent in 1993-94 and further to 48.9 per cent in 2011-12). In absolute terms, the number of people employed in this sector rose from 241.5 million in 1993-94 to 268.6 million in 2004-05 (a rise of 27.1 million). However, the number of people employed in agriculture fell after 2004-05 and stood at 231.9 million in 2011-12. Thus, over the seven year period 2004-05 to 2011-12, as many as 36.7 million workers abandoned agriculture (which was nearly 16 per cent of the total workforce in agriculture in 2011-12). ***This absolute decline in the number of workers in Indian agriculture after 2004-05 occurred for the first time in India's post-Independence economic history*** and is indicative of a ***structural transformation*** that is now taking place on the employment front in our economy. According to Santosh Mehrotra *et al.*, ***"This structural shift ... is precisely the kind of progressive structural change in employment that should accompany a structural shift in output between the primary, secondary and tertiary sectors in any developing economy."***[5]

Table 12.2

Estimated Number of UPSS Workers Across Broad Industrial Categories: 1972-73 to 2011-12

Industry	*Percentage*				
	1972-73	*1983*	*1993-94*	*2004-05*	*2011-12*
I. Agriculture and allied activities	**73.9**	**68.6**	**64.8**	**58.5**	**48.9**
II. Industry	**11.3**	**13.8**	**14.7**	**18.1**	**24.4**
(i) Mining and Quarrying	0.4	0.6	0.7	0.6	0.5
(ii) Manufacturing	8.9	10.6	10.5	11.7	12.8
(iii) Electricity, Gas and Water Supply	0.2	0.3	0.4	0.3	0.4
(iv) Construction	1.8	2.3	3.1	5.6	10.6
III. Services	**14.8**	**17.6**	**20.5**	**23.4**	**26.7**
(i) Trade, Hotels and Restaurants	5.1	6.3	7.4	10.2	11.4
(ii) Transport, Storage and Communication	1.8	2.5	2.8	3.8	4.4
(iii) Financing, Real Estate, Business Services	0.5	0.7	0.9	1.5	2.6
(iv) Community, Social and Personal Services	7.4	8.1	9.4	7.7	8.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Institute for Human Development, *India Labour and Employment Report* 2014 (Delhi, 2014), Table 3.5, p. 208.

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2. The number of workers employed in manufacturing rose from 38.9 million in 1993-94 to 53.9 million in 2004-05 and further to 59.8 million in 2011-12.[6] However, in percentage terms, there has been no significant change in employment in the manufacturing sector during the period of the last three decades. As is clear from Table 12.2, as against 10.6 per cent of workers employed in manufacturing in 1983, 12.8 per cent of workers were employed in this sector in 2011-12.

3. Next in importance from the point of view of employment is trade, hotels and restaurants. This sector employed 7.4 per cent of workers in 1993-94 and 11.4 per cent in 2011-12.

4. ***The sector which has registered the fastest growth in recent times as far as employment generation is concerned, has been the construction sector.*** This is basically due to a large number of infrastructure projects being undertaken in recent years (particularly projects of road construction under NHDP, and projects under MGNREGS). As a result, while only 3.1 per cent of workers were engaged in the construction sector in 1993-94 and 5.6 per cent in 2004-05, there was a sudden jump to 10.6 per cent in 2011-12.

5. As a result of economic reforms in the post-1991 period, there has been substantial expansion in employment in: (*i*) transport, storage and communication and (*ii*) financing, real estate and business services. As can be calculated from Table 12.2, while 3.2 per cent of workers were employed in these sectors in 1983, this percentage rose to 5.3 per cent in 2004-05 and 7.0 per cent in 2011-12.

6. The sectors exhibiting a marked stability in terms of employment over 1983 to 2011-12 have been the sectors of: (*i*) mining and quarrying, and (*ii*) electricity, gas and water supply. Their combined share in total employment was 0.9 per cent both in 1983 and 2011-12.

7. A ***structural change*** in employment is evident from Table 12.2 with the share of agriculture declining over the entire five decade period 1972-73 to 2011-12 from as high as 73.9 per cent (*i.e.,* nearly three-fourths of total employment) to 48.9 per cent in 2011-12 (*i.e.,* less than half of total employment). The share of industry over the period rose from 11.4 per cent to 24.4 per cent and the share of services from 14.8 per cent to 26.7 per cent. However, as can be seen from Table 12.2, this ***structural shift*** has been the result of changes taking place in the economic reform period, i.e., the post 1991 period only. In this context, two comments are in order:

(*i*) The increasing share of industry in total employment is mainly the result of the massive expansion in the construction sector. However, the 'quality' of employment in this sector is not good as most of the people working in it have casual and temporary jobs and, are thus, not entitled to the benefits that accompany regular and permanent jobs (like casual and sick leave, medical benefits, social security cover etc.)

(*ii*) The 'backbone' of the industrial and economic progress, *i.e.,* the manufacturing sector, continues to face stagnation in terms of employment. Even in 2011-12, this sector could employ only 12.8 per cent of the people. Without a rapid growth of the manufacturing sector, the country will not be able to push up economic growth to any significant heights. The Government of India has realised this fact and is thus putting in efforts to expand the manufacturing sector. As far as employment is concerned, the National Manufacturing Policy (NMP) announced by the government on November 4, 2011 calls for the creation of 100 million additional jobs in the manufacturing sector by 2022.

8. Gender-wise sectoral distribution of workers reveals the following information: ***as far as male workers are concerned, 58.3 per cent of these workers were employed in agriculture in 1993-94 and this percentage fell by 43.6 per cent in 2011-12*** (a decline of almost 15 percentage points). This was basically due to the fact that more and more male workers are now shifting to other sectors of the economy, particularly the construction sector. In fact, the share of the construction sector in total male employment rose from 4.1 per cent in 1993-94 to as high as 12.3 per cent in 2011-12.

As far as female workers are concerned, 78.1 per cent (i.e., more than three-fourths) of these workers were employed in agriculture in 1993-94. This percentage fell to 62.8 per cent in 2011-12 (a decline of about 15 percentage points). The share of the construction sector in female employment rose from a meagre 1.2 per cent in 1993-94 to 6.1 per cent in 2011-12.

Employment in Informal and Unorganised Sectors

What is Informal Sector? The term 'informal sector' is used to denote tiny units, engaged in the production of goods and services but whose activities are not recognised, recorded, protected or regulated by the public authorities. A wide range of activities from begging, street vending, shoe-shining, garbage sifting, food processing and other petty activities requiring little or no capital and skills to activities involving some amount of skill and capital such as tailoring, repair of electrical and electronic goods, operation of transport equipment etc. are included in the informal sector.

What is Unorganised Sector? In the Indian NAS (National Accounts Statistics), the organised sector includes all establishments in the public sector and all non-agricultural establishments in the private sector employing 10 or more

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workers. All units complementary to the above coverage of organised sector, comprise the unorganised sector.

People working in the informal and unorganised sectors of the economy have low wage, no income security, long working hours, no sick leave, no social security etc. and their living conditions are bad. The income levels of many of them are too insufficient to provide even the most rudimentary shelter. Many lives in slums or pavements.

The above description shows that a large percentage of informal and unorganised sector employment means that the 'quality of employment' is poor.

Employment in the unorganised sector was as high as 86.3 per cent in 1999-2000 and 2004-05 of total employment though it fell somewhat to 82.7 per cent in 2011-12. As a result, organised sector employment rose from 13.7 per cent in 1999-2000 and 2004-05 to 17.3 per cent in 2011-12. However, the increase in the organised sector employment has been mainly in the informal sector (from 37.9 per cent in 1999-2000 to 46.5 per cent in 2004-05 and 54.6 per cent in 2011-12). The informal employment in the unorganised sector remained the same (99.7 per cent).

As far as employment in the informal sector is concerned, it was 91.1 per cent of total employment in 1999-2000. ***The share of informal sector employment in total employment rose to 92.7 per cent in 2004-05 and stood at 91.9 per cent in 2011-12.*** This shows that only 8 per cent of people work in the formal sector. This is a matter of serious concern. Another significant observation is that formal employment in the organised sector is not increasing (it was 33.7 million in 1999-2000, 33.4 million in 2004-05 and just 30.74 million in 2009-10). This points to the fact that ***organised enterprises' employers are increasingly hiring workers on contractual terms.***

Employment in Public and Private Sectors

Information on employment in public sector and private sector is presented in Table 12.3. A little calculation on the Table shows that the public sector's share in total employment in these two sectors was 67.7 per cent in 1981. This rose to 71.3 per cent in 1991 but fell thereafter. This was the result of a conscious policy decision by the government to reduce employment in the public sector. As a result of this policy, the share of public sector in employment in the two sectors fell to 68.9 per cent in 2001, 68.1 per cent in 2005 and further to 59.6 per cent in 2012. As can be seen from Table 12.3, the rate of growth of employment in the two sectors combined was 1.20 per cent per annum over the period 1983-94 but decelerated considerably to only 0.46 per cent per annum during 1991-2012. This decline was mainly due to a decrease in employment growth in the public sector establishments from 1.53 per cent per annum in the earlier period to (–) 0.36 per cent per annum in the later period. The private sector, on the other hand, showed accelerated growth from 0.44 per cent per annum to 2.03 per cent per annum.

Increasing Casualisation

Data on employment status by category of employment shows the phenomenon of increasing casualisation over the years 1972-73 to 2011-12. This would be clear from a glance at Table 12.4.

Table 12.4 presents information on employment status by category of employment for males and females separately both in rural areas and urban areas. A glance at this table shows that the entire period of 1972-73 to 2009-10 can be divided into two distinct periods – 1972-73 to 2011-12 and then 1999-2000 to 2011-12. During the first period, a clear trend of casualisation of workforce is evident (excepting the category of urban females). For instance, in the category of rural males, the share of casual labour in total employment rose from 22.0 per cent in 1972-73 to 36.2 per cent in 1999-2000. In the category of rural females, the share of casual labour rose from 31.4 per cent to 39.6 over the same period while in the category of urban males, the share of casual labour increased from 10.1 per cent to 16.8 per cent. This shows that ***there was an evidence of increasing casualisation of workforce over the period 1972-73 to 1999-2000 in both rural and urban areas.*** As far as rural areas are concerned, agriculture proved to be incapable of productively absorbing the growing rural labour force. As a result, people increasingly

Table 12.3

Employment in Public and Private Sectors

	1981	1991	2001	2005	2011	2012	Rate of growth of employment (% per annum)	
	In lakh						1983 to 1993-94	1991 to 2012
Public Sector	154.8	190.6	191.4	180.1	175.5	176.1	1.53	–0.36
Private Sector	74.0	76.8	86.5	84.5	114.2	119.4	0.44	2.03
Total	228.8	267.4	277.9	264.6	289.7	295.5	1.20	0.46

Sources: EPW Research Foundation, *India: A Pocket Book of Data Series, 2012* (Delhi, 2012), Table 164, p. 170 and Table 165, p. 171; Government of India, *Economic Survey*, 2010-11 (Delhi, 2011), Table 12.9, p. 299; and *Economic Survey* 2016-17 (Delhi, 2017), Volume II, Statistical Appendix, Table 3.1, p. A61.

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Table 12.4

Employment Status by Category of Employment, 1972-73 to 2011-12

(Percentage)

Employment Status and Year	Rural		Urban		Total	
	Male	Female	Male	Female	Male	Female
Self-employed						
1972-73	65.9	64.5	39.2	48.4	60.6	63.0
1987-88	58.6	60.8	41.7	47.1	54.3	58.9
1993-94	57.9	58.5	41.7	45.4	52.9	56.7
1999-2000	55.0	57.3	41.5	45.3	52.8	55.6
2004-05	58.1	63.7	44.8	47.7	—	—
2009-10	53.5	55.7	41.1	41.1	50.0	53.3
2011-12	54.5	59.3	41.7	42.8	50.7	56.1
Regular employees						
1972-73	12.1	4.1	50.7	27.9	19.7	6.3
1987-88	10.0	3.7	43.7	27.5	18.6	6.9
1993-94	8.3	2.8	42.1	28.6	17.0	6.3
1999-2000	8.8	3.1	41.7	33.3	14.0	7.3
2004-05	9.0	3.7	40.6	35.6	—	—
2009-10	8.5	4.4	41.9	39.3	17.7	10.1
2011-12	10.0	5.6	43.4	42.8	19.8	12.7
Casual labour						
1972-73	22.0	31.4	10.1	23.7	19.7	30.7
1987-88	31.4	35.5	14.6	25.4	27.1	34.2
1993-94	33.8	38.7	16.2	26.2	30.1	37.0
1999-2000	36.2	39.6	16.8	21.4	33.2	37.1
2004-05	32.9	32.6	14.6	16.7	—	—
2009-10	38.0	39.9	17.0	19.6	32.2	36.6
2011-12	35.5	35.1	14.9	14.3	29.4	31.2

Source: EPW Research Foundation, *India: A Pocket Book of Data Series* 2012 (Delhi, 2012), Table 169, p. 175, and NSSO, 68th Round, *Employment and Unemployment in India,* 2011-12 (June 2013), Table 4, p.18.

sought employment in non-agricultural activities (like construction, trade and services). According to Papola, while some casualisation in rural areas was 'distress driven', as small and marginal land holders and land labourers, unable to find gainful work in agriculture, were forced to take up whatever work the non-agricultural sector offers, some people opted for non-agricultural activities as they offer better earnings. In urban areas, displacement of regular workers from large enterprises increased the casualisation of labour force.[7]

As is clear from Table 12.4, the period between the 55th Round of NSSO (pertaining to the year 1999-2000) and the 61st Round of NSSO (pertaining to the year 2004-05), saw a reversal of sorts as all four categories (rural males, rural females, urban males and urban females) saw a decline in the percentage of casual labour. This happened almost exclusively as a result of expansion of self-employment. However, the period 2004-05 to 2009-10 was again marked by an increase in the casualisation of labour force. The percentage of casual labour force in all four categories increased with the highest increase being recorded in the case of rural females followed by rural males (from 32.8 per cent to 39.9 per cent in the former case and from 32.9 per cent to 38.0 per cent in the latter case). Subhanil Chowdhary opines that ***the increase in the casualisation of labour force in the five year period could be due to an increase in employment in the construction sector — due to NREGA in the rural areas (which mainly involves construction work) and real estate development in the urban areas that is happening at a rapid pace in India.***[8]

As is clear from Table 12.4, there was a stagnation in the proportion of regular wage and salary earners over the entire period 1972-73 to 2009-10. It is only in the category of urban female employees that one finds a percentage increase but this is offset by a decline in other categories. This stagnation was due to slow growth of employment in the organised sector. As noted in Table 12.4, rate of growth of employment in the organised sector was only 1.2 per cent over the period 1983 to 1993-94 and this fell further to a meagre 0.05 per cent over the period 1994 to 2008. As a result, the share of unorganised sector employment increased.

NSSO 68th Round Results. Table 12.4 also contains information for the year 2011-12 obtained from 68th Round of NSSO. As is clear, ***in 2011-12, majority of male and female workers were engaged in self-employment —***

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51 per cent in the case of male workers and 56 per cent in the case of female workers. The share of casual labour employment in total workforce of both males and females was significant — 29.4 per cent among male workers and 31.2 per cent among female workers. The percentage share in different status in employment in the total workforce of urban males and urban females were almost at the same level. In the rural areas, the share of casual labour in the total workforce of males and females was almost the same (35.5 per cent for males and 35.1 per cent for females); self-employment was higher for females (54.5 per cent for males and 59.5 per cent for females); and regular employment was higher for males (10 per cent for males and 5.6 percent for females).

In 2011-12, the share of regular employees in the total workforce of urban areas was much higher as compared to the rural areas — about 43 per cent in urban areas *vis-à-vis* about 9 per cent in rural areas. The share of casual labour in the total workforce of rural areas was about 35 per cent as against 15 per cent in the urban areas. ***The share of self-employed, regular employees and casual labour in the total workforce was 52 per cent, 18 per cent and 30 per cent respectively in 2011-12*** (data not given in the Table).

NATURE AND ESTIMATES OF UNEMPLOYMENT IN INDIA

Unemployment in underdeveloped countries is both open and disguised. Like all other underdeveloped countries, India presently suffers mainly from structural unemployment which exists in open and disguised forms.

Nature of Unemployment

Most of the unemployment in India is definitely structural. During the 1951-2011 period, population in this country increased at an alarming rate of around 2.1 per cent per annum and with it the number of people coming to the labour market in search of jobs also rose rapidly, whereas employment opportunities did not increase most of the time correspondingly due to slow economic growth. Hence, there has been "an increase in the volume of unemployment from one plan period to another."[9] This unemployment, on account of its very nature, can be eliminated only by introducing certain radical reforms in the structure of the economy. Apart from structural unemployment, there is Keynesian involuntary unemployment which can be eliminated by increasing effective demand, as is done in developed countries. Though presently it would be wrong to ignore the Keynesian involuntary unemployment, yet ***the structural unemployment remains a greater cause of anxiety.***

Concepts of Unemployment

Keeping in view the recommendations of the Committee of Experts on Unemployment, the National Sample Survey Organisation (NSSO) has developed and standardised concepts and definitions of labour force, employment and unemployment suitable to Indian conditions. These concepts have not only been adopted by the NSSO for conducting surveys on employment since 1972-73, but have also been accepted by the Planning Commission for analysing the dimension of the unemployment problem. ***The three concepts of unemployment developed by the NSSO are: (i) Usual Status Unemployment, (ii) Current Weekly Status Unemployment, and (iii) Current Daily Status Unemployment.***

(i) **The Usual Status** concept is meant to determine the Usual Activity Status — employed, or unemployed or outside the labour force — of those covered by the survey. The activity status is determined with reference to a longer period, say a year preceding to the time of survey. The persons covered by the survey may be classified into those working and/or available for work in their principal activity sector, and those working and/or available for work in a subsidiary sector, that is, a sector other than their principal activity sector. Hence, within the Usual Status concept, the estimates are now derived on the Usual Principal Status as well as Usual Principal and Subsidiary Status basis. ***The Usual Status unemployment rate is a person rate and indicates chronic unemployment because all those who are found "usually" unemployed in the reference year are counted as unemployed.***

(ii) **The Current Weekly Status** concept determines the activity status of a person with reference to a period of preceding seven days. If in this period a person seeking employment fails to get work for even one hour on any day, he (or she) is deemed to be unemployed. ***A person having worked for an hour or more on any one or more days during the reference period gets the employed status. The Current Weekly Status unemployment rate, like the Usual Status unemployment rate, is also a person rate.***

(iii) **The Current Daily Status** concept considers the activity status of a person for each day of the preceding seven days. ***A person who works for one hour but less than four hours is considered having worked for half a day. If he works for four hours or more during a day, he is considered as employed for the whole day. The Current Daily Status unemployment rate is a time rate.***

Out of these concepts of unemployment, the Current Daily Status concept provides the most appropriate measure of unemployment. Raj Krishna states, ***"The daily status***

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Table 12.5

Unemployment Rates by Sex, Residence and Status (Per cent)

Year	Unemployment Rate					
	Male			Female		
	UPSS	CWS	CDS	UPSS	CWS	CDS
Rural						
1972-73	1.2	3.0	6.8	0.5	5.5	11.2
1977-78	1.3	3.6	7.1	2.0	4.1	9.2
1983	1.4	3.7	7.5	0.7	4.3	9.0
1987-88	1.8	4.2	4.6	2.4	4.4	6.7
1993-94	1.4	3.1	5.6	0.9	2.9	5.6
Urban						
1972-73	4.8	6.0	8.0	9.0	9.2	13.7
1977-78	5.4	7.1	9.4	12.4	10.9	14.5
1983	5.1	6.7	9.2	4.9	7.5	11.0
1987-88	5.2	6.6	8.8	6.2	9.2	12.0
1993-94	4.1	5.2	6.7	6.1	7.9	10.4

Notes: UPSS = Usual Principal and Subsidiary Status
CWS = Current Weekly Status
CDS = Current Daily Status

Source: *Revised Report No. 406 (Key Results of 50th Round of NSS)* and *Reports on Successive Rounds of NSSO Surveys on Employment and Unemployment.*

flow rate is evidently the most inclusive, covering open as well as partial unemployment. It is therefore the rate which is most relevant for policy-making."[10] In India, the problem of chronic unemployment is far less serious as compared with the enormous problem of the discontinuous underemployment of a section of the labour force whose composition keeps on changing over time. This factor has important policy implications and has thus to be kept in mind while employment programmes are chalked out.

Estimates of Unemployment (1972-73 to 1993-94)

The unemployment rates by the three alternative concepts of the Usual Status, the Current Weekly Status and the Current Daily Status have become available from the various Rounds of NSSO (National Sample Survey Organisation) surveys for the years 1972-73, 1977-78, 1983, 1987-88 and 1993-94. These are given in Table 12.5.

The rates of unemployment do not indicate any clear trends over the 21 years period, that is, from 1972-73 to 1993-94. However, if we compare unemployment position in 1993-94 with that in 1983 and 1972-73, we observe that there has been marginal decline in unemployment rates.

For the purpose of realising the goal of "employment for all" over a period, an assessment of the backlog of unemployment in the base year and likely additions to the labour force during the reference period has to be made. Till recently the latest survey based estimates of unemployment were available for 1987-88 only. Therefore, the Planning Commission had independently estimated labour force and employment on April 1, 1992 to yield the magnitude of unemployment. Total employment in terms of the Current Weekly Status was estimated to be 301.7 million as against the labour force estimate of 319 million. Thus, backlog of unemployed in terms of the Current Weekly Status on April 1, 1992 was 17 million. According to the NSSO, about 2 per cent of those recorded as employed by the Current Weekly Status had work for half or less than half the time. They being severely underemployed were included in the estimates of backlog for employment planning. Thus, ***according to the Planning Commission, those of the people who looked for full-time new employment opportunities were around 23 million in April 1992.***

Unemployment in Post-reform Period

As is clear from Table 12.6, at the all-India level the estimates of current daily status unemployment indicate a worsening of the unemployment situation during the period of economic reform in all the four population segments, viz., rural males, rural females, urban males and urban females. The increase in the current daily status unemployment rate between 1993-94 and 2004-05 was the steepest for rural females (from 56 per thousand in 1993-94 to 87 per thousand in 2004-05). The second highest increase was in the case of rural males. In their case, the unemployment rate increased from 56 per thousand in 1993-94 to 80 per thousand in 2004-05.

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Table 12.6

Unemployment Rates (per 1,000) for 1993-94 and 2004-05

NSSO Round	*Rural Males*			*Rural Females*		
	US	*CWS*	*CDS*	*US*	*CWS*	*CDS*
1993-94 (50th Round)	20	30	56	14	30	56
1999-2000 (55th Round)	21	39	72	15	37	70
2004-05 (61st Round)	21	38	80	31	42	87
NSSO Round	*Urban Males*			*Urban Females*		
	US	*CWS*	*CDS*	*US*	*CWS*	*CDS*
1993-94 (50th Round)	45	52	67	83	84	105
1999-2000 (55th Round)	48	56	73	71	73	94
2004-05 (61st Round)	44	52	75	91	90	116

Notes: US: Usual Status, CWS: Current Weekly Status, CDS: Current Daily Status
Source: NSSO's 61st Round Survey on Employment and Unemployment conducted in 2004-05.

Eleventh Five Year Plan identified the following weaknesses on the employment front during the period of economic reforms:[11]

1. The rate of unemployment has increased from 6.1 per cent in 1993-94 to 7.3 per cent in 1999-2000 and further to 8.3 per cent in 2004-05.
2. Unemployment among agricultural labour households has risen from 9.5 per cent in 1993-94 to 15.3 per cent in 2004-05.
3. Underemployment seems to be on the rise, as is evident from a widening gap between the usual status and the current daily status measures of creation of incremental employment opportunities between the periods 1994 to 2000 and 2000 to 2005 (usual status unemployment rate was 2.18 in 1993-94 while current daily status unemployment rate was 6.38. In 1999-2000, these rates were 2.48 and 7.58 respectively. In 2004-05, while usual status unemployment rate rose to 2.60, the current daily status unemployment rate rose to as high as 8.54).
4. While non-agricultural employment expanded at a robust annual rate of 4.7 per cent during the period 1999-2000 to 2004-05, this growth was largely in the unorganised sector.
5. Despite fairly healthy GDP growth, employment in the organised sector actually declined, leading to frustration among the educated youth who have rising expectations.

NSSO 66th Round Results. Information on rural and urban unemployment rates for the year 2009-10 is available in 66th Round Survey of NSS. This is presented in Table 12.8. As is clear from this table, the CDS estimate of unemployment is the highest. According to *Economic Survey* 2011-12, the higher unemployment rates according to the CDS approach compared to the weekly status and usual status approaches indicate a high degree of intermittent unemployment. Under both the UPSS and CWS approaches, urban unemployment was higher than rural unemployment in 2009-10. However, rural unemployment was higher under the CDS approach. "This possibly indicates higher intermittent seasonal unemployment in rural than urban areas, something that employment generation schemes like the MGNREGA need to pay attention to."[12]

However, as is clear from Table 12.7, overall unemployment rates were lower in 2009-10 under each approach *vis-à-vis* 2004-05. The unemployment rate under UPSS declined from 2.4 per cent in 2004-05 to 2.1 per cent in 2009-10. As would be clear from Table 12.1, the total number of unemployed under the UPSS approach also

Table 12.7

All-India Rural and Urban Unemployment Rates for 2009-10

Estimate	*Rural 2009-2010*	*Urban 2009-2010*	*Total 2009-2010*	*Total 2004-2005*
1. UPSS	1.6	3.4	2.1	2.4
2. CWS	3.3	4.2	3.6	4.4
3. CDS	6.8	5.8	6.6	8.2

Source: Government of India, *Economic Survey,* 2011-12 (Delhi, 2012), Table 13.7, p. 307.

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declined from 11.2 million in 2004-05 to 9.8 million in 2009-10. There was a large slowdown in employment generation during this period (as shown in Table 12.1, the rate of employment generation which was 2.83 per cent per annum during the period 1999-2000 to 2004-05 declined to only 0.21 per cent per annum over the period 2004-05 to 2009-10). The question is: how could the total number of unemployed decline in the face of such a large slowdown in employment generation? ***The answer clearly lies in the fact that the actual labour force had declined.***[13]

NSSO 68th Round Results. Information on rural and urban unemployment rates for the year 2011-12 is available in 68th Round Survey of NSSO. This is presented in Table 12.8.

Table 12.8

All-India Rural and Urban Unemployment Rates for 2011-12

Estimate	*Rural*	*Urban*	*Total*
1. UPS	2.3	3.8	2.7
2. UPS (adjusted)	1.7	3.4	2.2
3. CWS	3.4	4.4	3.7
4. CDS	5.7	5.5	5.6

Source: NSSO 68th Round, *Employment and Unemployment in India,* 2011-12 (June 2013), Table 3, p. 15.

As is clear from this Table, unemployment rate according to UPS (adjusted) approach was 2.2 per cent in 2011-12. Compared to the unemployment rate in rural areas, unemployment rate was higher in urban areas — 1.7 per cent in rural areas and 3.4 per cent in urban areas. Unemployment rates in CWS were considerably higher as against UPS (adjusted) — almost double. ***Unemployment rates estimated according to the CDS approach were the highest — 5.7 per cent in rural areas and 5.5 per cent in urban areas (5.6 per cent overall).***

It may also be noted at this juncture that according to 68th Round, unemployment rates for females were higher than for males in all categories according to all approaches (excepting rural unemployment category under UPS (adjusted) where they were equal at 1.7 per cent). According to CDS approach, urban unemployment rate for females was as high as 8 per cent as against 4.9 per cent for males.

Unemployment in 2015-16. The results of Employment and Unemployment Survey (EUS) conducted by the Labour Bureau, Ministry of Labour and Employment, for the year 2015-16 are presented in Table 12.9. As is clear from the Table, the Labour Force Participation Rate (LFPR) at the all India level based on usual principal status approach was estimated at 50.3 per cent, Worker Population Ratio (WPR) was 47.8 per cent and the unemployment rate was 5.0 per cent in 2015-16. The All India LFPR of females at 23.7 per cent is much lower than that of males (at 75.0 per cent). Moreover, the unemployment rate for females is higher than that of males across rural and urban areas.

Table 12.9

LFPR, WPR and UR based on Usual Principal Status (UPS), 2015-16

	Rural			*Urban*			*Total*		
Parameter	*M*	*F*	*P*	*M*	*F*	*P*	*M*	*F*	*P*
LFPR	77.3	26.7	53.0	69.1	16.2	43.5	75.0	23.7	50.3
WPR	74.1	24.6	50.4	66.8	14.3	41.4	72.1	21.7	47.8
UR	3.2	7.8	5.1	3.3	12.1	4.9	4.0	8.7	5.0

Notes: LFPR: Labour Force Participation Rate, WPR: Worker Population Ratio, UR: Unemployment Rate.

Source: Government of India, *Economic Survey* 2016-17 (New Delhi, 2017), Table 14, p. 161.

Unemployment in 2017-18. According to the first annual PLFS (Periodic Labour Force Survey) published in 2017-18, unemployment rate in India stood at 6.1 per cent in 2017-18 with 5.3 per cent in rural areas and 7.8 per cent in urban areas as per usual status. As per current weekly status, the UR was 8.9 per cent with 8.5 per cent in rural areas and 9.6 per cent in urban areas.

Estimates by ILO

International Labour Organisation (ILO) released its *World Employment and Social Outlook Report 2018* on January 23, 2018. According to this Report, ***the number of unemployed people in India was 18.3 million in 2017 which was 9.49 per cent of world's unemployed population.*** In 2019, the number of unemployed people in India is projected to rise to 18.9 million (9.76 per cent of world's unemployed people in that year). According to the Report, the unemployment rate in India in 2017 was 3.5 per cent and is expected to be 3.5 per cent in 2019 as well. The unemployment rate in the 15-24 age group was 10 per cent in 2014 which is estimated to have increased to 10.7 per cent in 2019.[14]

UNEMPLOYMENT IN URBAN AREAS

Most of the unemployment in urban areas is open and undisguised. Unemployment of this kind is not only painful at a personal level, but it is also a source of social tensions, which often threatens the whole fabric of society. Despite this problem of unemployment and its attendant dangers, the government has not given adequate attention to it. Even the estimates of urban unemployment have not been prepared

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on a regular basis. However, the National Sample Survey Organisation (NSSO) has made estimates of unemployment in different years. These estimates are surely not comparable. However, they suggest that unemployment in the urban sector has fluctuated around 10 per cent of the labour force in recent decades. This, at least, shows that there were no dramatic increases in perceived employment opportunities. In fact, the rate of growth of urban employment which was 3.10 per cent per annum during the period 1983 to 1993-94 fell to 2.90 per cent per annum during the period 1993-94 to 2011-12.

Two relatively important forms of urban unemployment are: (*i*) industrial unemployment, and (*ii*) educated unemployment.

Industrial Unemployment

The exact size of the industrial unemployment in India is not known because the necessary data for its estimation are not available. However, it is generally expected that with economic growth, the industrial sector expands and generates more and more employment opportunities. In India, the manufacturing sector has indeed expanded and employment in it has steadily increased. But, in percentage terms, its share in employment has failed to increase and has hovered between 10 to 12 per cent over the years (see Table 12.2). One of the important reasons for this is the low employment elasticity in the manufacturing sector (it was 0.78 in the period 1972-73 to 1983, 0.47 in the period 1993-94 to 2004-05 and just 0.13 in the period 2004-05 to 2011-12). As a result, industrial unemployment increased.

The other factors which have contributed to an increase in industrial unemployment over the years are many. First, there has been a large increase of the economically active population in the country, while the economy has failed to grow at a pace commensurate with the growth of labour force. Secondly, population in urban areas has grown faster than in rural areas, because of the migration on a large scale from villages to cities. The industrial growth in India since Independence has been very modest. Moreover, since early 1990s industrial growth has been jobless and has failed to absorb all those who migrated to cities with the hope of getting some job or the other. There is widespread disguised unemployment in agriculture. The decay of cottage and small-scale rural industries in the countryside has further contributed to the already bad employment situation in the countryside. These factors are pushing lots of people out of villages; cities have their own attractions as well. Thus, migration from the countryside to urban centres is a regular process. In normal times some of the migrants get jobs in industries, some get absorbed in the unorganised sector and the rest wait for their chance to get employment and thus swell the number of unemployed.

It is often contended that industrial unemployment has increased in the country especially because of the slow industrialisation process and inappropriate technology. Near stagnation in the industrial sector from the mid-1960s to the early-1980s rendered various remedial measures ineffective. Concentration of industries in big cities is another major source of the malady. Industrial concentration attracts labour force to cities in a big way — much more than what the industries can absorb at any point of time. If the policy of dispersal of industries is adopted and industries are set up in rural and semi-urban areas, this problem can be tackled satisfactorily.

Educated Unemployment

Educated unemployment is, by and large, a part of urban unemployment. It is a very serious and menacing problem, yet the size of educated unemployment remains largely unmeasured. Not only are there conceptual difficulties in estimating it, but the kind of statistical information that is required for its estimation is also not available. Hence, the quantitative base for analysing the problem of educated unemployment is weak. Nonetheless, on the basis of fragmentary information that is available, it is not difficult to understand the basic issues involved in the problem.

The Planning Commission's estimates suggest that at the beginning of 1980, approximately 34.72 lakh educated persons were unemployed. Using the same approach as in the Sixth Plan, unemployment among the educated people works out to 47 lakh in 1985 and 68 lakh in 1992. No estimates of educated unemployment are available for a recent year. However, there are no reasons to believe that educated unemployment is now less than what was there on the eve of the Eighth Plan. The large number of educated unemployed shows "a mismatch between the kind of job opportunities that are needed and that are available in the job market."[15]

There are many causes of educated unemployment. ***The defective educational system, with its theoretical bias, lack of aptitude and technical qualifications for various types of work among job-seekers and maladjustments between demand and supply of educated workers are some well-known causes of educated unemployment.*** But the major cause of unemployment in this sector is the same which explains the overall unemployment in the country. Over the years, economic growth in India has been very slow. It was inadequate in the past to absorb all the educated persons. In fact, supply of educated workers has consistently moved ahead of demand so that educated unemployment has not diminished. This happened largely because of the wide gap between the private cost of education and the expected return from it. In India, private cost of higher

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education is much less than the expected gains from it. Thus an unnecessarily large number of people pursue higher education. They have one-dimensional approach, that is, they simply wish to improve their employment prospects, but in doing so they create conditions which render lesser educated persons as unemployed. According to Blaug, Layard and Woodhall, ***the educated unemployment, in itself, is no proof of over investment in education. Since it is caused by market imperfections, "the appropriate remedy might, therefore, involve an 'active manpower policy' designed to improve the functioning of labour markets rather than a contraction of upper secondary and higher education."***[16]

AGRICULTURAL UNEMPLOYMENT

According to the NSS, the Current Daily Status rural unemployment rate for male workers was 5.6 per cent in 1993-94. It rose to as high as 8.0 per cent in 2004-05 but declined thereafter to 5.5 per cent in 2011-12. ***The CDS unemployment rate for rural workers as a whole was 8.2 per cent in 2004-05 and 5.7 per cent in 2011-12.*** Most of this unemployment is agricultural unemployment which may be classified into: (*i*) seasonal unemployment, (*ii*) disguised unemployment, and (*iii*) chronic and usual status unemployment.

Seasonal Unemployment

Seasonal unemployment in agriculture is a normal condition in India. In 2011-12, gross irrigated area as a percentage of gross cropped area was only 46.9 per cent. However, two or more crops are prepared on not more than 28 per cent cultivable land. This implies that farmers cultivating approximately 72 per cent of the land remain involuntarily unemployed for 3 to 4 months, unless they find some temporary employment in this period. Since the percentage of the lucky ones who manage to get some work in the off-season is quite low, the incidence of seasonal unemployment in the agricultural sector is obviously very high.

Agricultural labourers in India rarely have work throughout the year. According to the Second Agricultural Labour Enquiry Committee, agricultural labour in this country had 237 days employment in 1956-57. In other words, on an average their unemployment was approximately for 3 to 4 months. The Planning Commission in its *Mid-Term Appraisal of the Fourth Plan* had pointed out that leaving aside the green revolution belt, in all other areas seasonal unemployment during the early 1970s was at least as much as during the 1950s, if not more. However, considering the decline in employment elasticity, measured as the ratio of employment growth to the growth of value added, in the agricultural sector during the 1990s and 2000s, there is every reason to believe that the seasonal unemployment should have increased in recent years. The employment elasticity in agriculture which was 0.46 over the period 1972-73 to 1983, declined to just 0.26 during 1993-94 to 2004-05 and turned negative (–0.42) during 2004-05 to 2011-12.

Disguised Unemployment

The Indian agriculture is characterised by the existence of considerable amount of surplus labour. However, no firm estimates of its size are available. Some initial attempts to measure surplus labour in agriculture were of Shakuntala Mehra,[17] J.P. Bhattacharjee[18] and Ashok Rudra[19] While the studies of J.P. Bhattacharjee and Ashok Rudra focused on estimating surplus labour in selected villages of West Bengal and Bihar, Shakuntala Mehra attempted to provide estimates of disguised unemployment in agriculture for the country as a whole. She estimated that 17.1 per cent of the workforce in agriculture was surplus during the 1960s.

The latest attempt in measuring the extent of surplus labour has been made by Ajit K. Ghose in *India Employment Report* 2016. This Report presents estimates of surplus labour for the country as a whole (and not only the agricultural sector). According to this Report, ***in 2015-16, the currently surplus workers were 52 million (which was 8 per cent of the non-student working-age population)*** and the total surplus workers were 104 million (about 15 per cent of the non-student working-age population).[20] This shows that the incidence of surplus labour in India's economy is quite large.

Usual Status Unemployment

Usual Status unemployment in rural areas cannot be clearly distinguished from seasonal and disguised unemployment. It is this reason why people remaining unemployed for long periods are sometimes counted as seasonally or disguisedly unemployed. This error crops up particularly if the survey is carried out in the off-season when most people in villages do not have any productive work with them. Information on Usual Status unemployment rate is presented in Tables 12.6, 12.7, 12.8 and 12.9.

CAUSES OF UNEMPLOYMENT

The foregoing analysis of unemployment in India has made it evidently clear that most of the unemployment in this country is structural. Its main causes are discussed below:

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1. Jobless growth. The rate of growth of employment in India has been considerably less than the rate of economic growth. Gross domestic product growth was 6.2 per cent per annum over the period 1980-81 to 2011-12 (it was even higher at 8.4 per cent per annum during 2003-04 to 2011-12). As against this, total employment growth was far slower at 2 per cent per annum during 1983-1993/94, 1.8 per cent per annum during 1993-94 to 2004-05 and just 0.45 per cent per annum during 2004-05 to 2011-12.[21] Employment elasticity declined progressively over time across sectors. During the period 2004-05 to 2011-12 when output growth was most rapid, employment elasticity was just 0.04 (i.e., almost zero). As stated earlier in this chapter, employment elasticity in agriculture had turned negative (–0.42) during this period. ***This indicates a situation of "jobless growth"***. The impressive pace of economic growth was driven by increases in labour productivity rather than increases in employment. Deepak Nayyar alleges that such jobless growth was neither an accident nor a coincidence. It was the result of economic policies that focused squarely on growth. A study of Labour Bureau's Employment-Unemployment Survey by Vinoj Abraham finds that there was actually an ***'employment loss'*** of 37.4 lakh to 53 lakh during the three-year period 2013-14 to 2015-16. According to Vinoj Abraham, ***"Perhaps this is for the first time in independent India that we have an absolute decline in employment, though there had been phases of employment growth being low at about 1 per cent during 1993-94 to 1999-2000 and below 1 per cent during 2004-05 to 2011-12".***[22] A study by BSE-CMIE (Centre for Monitoring Indian Economy) shows that the phenomenon of job losses continued in 2017 as well – with number of persons employed declining from 406.5 million in 2016 to less than 405 million in 2017.[23] Mahesh Vyas's conjecture is that this could be the after-effect of demonetisation. Data also reveal that gross investment fell from 39.4 per cent of GDP in 2011-12 to 33.8 per cent in 2013-14 and further to 33.3 per cent in 2015-16. This sharp fall in investments translated into a fall of the rate of jobs creation over the period. Investment data for 2016-17 and 2017-18 are not yet available but many observers feel that due to demonetisation and GST, poor investment trends must have prevailed in these years as well.

2. Increase in labour force. Since Independence, death rate has rapidly declined and the country has entered the second stage of demographic transition. Over the years, mortality rate has declined rapidly without a corresponding fall in birth rate and the country has thus registered an unprecedented population growth. This was naturally followed by an equally large expansion in labour force. In Indian context, social factors affecting the labour supply are as much important as demographic factors. Since Independence, education among women has changed their attitude towards employment. Many of them now compete with men for jobs in the labour market. The economy has, however, failed to respond to these challenges and the net result is continuous increase in unemployment backlog. In rural areas, whereas on account of growing labour force, unemployment has increased mainly in disguised form, in urban areas it is open and visible.

3. Inappropriate technology. In India, while capital is a scarce factor, labour is available in abundant quantity. Under these circumstances, if market forces operate freely and efficiently, the country would have labour-intensive techniques of production. However, not only in industries, but also in agriculture, producers are increasingly substituting capital for labour. In the Western countries, where capital is in abundant supply, use of automatic machines and other sophisticated equipment is both rational and justified while in India, on account of abundance of labour, this policy results in large unemployment.

According to W.A. Lewis, in all those countries where unskilled labour is available in excess supply, great care is needed in exercising choice in respect of techniques because monetary wage fails to reflect the real cost of labour. When labour is in excess supply at prevailing monetary rates of return, capital would not be considered productive, if it does the same work which labour also does with an equal amount of efficiency. Lewis asserts that investment in such a situation in capital equipment may be profitable to individual capitalists, but it is certainly not beneficial to the society, because it increases unemployment and not production.[24]

4. Inappropriate educational system. The educational system in India is defective. It is, in fact, the same educational system which Macaulay had introduced in this country during the colonial period. According to Gunnar Myrdal, India's educational policy does not aim at development of human resources. It merely produces clerks and lower cadre executives for the government and private concerns. With the expansion in the number of institutions which impart this kind of education, increase in unemployment is inevitable. It is so because education in arts, commerce and science will not ensure employment on account of its limited utility for productive purposes. Myrdal considers all those who receive merely this kind of education not only as inadequately educated but also wrongly educated.[25] Myrdal's criticism of India's educational system is valid. If the problem of unemployment is to be solved in this country, radical changes will have to be made in the educational system. Any educational system which fails to develop human resources properly will not be able to provide employment to all those who have received it and, accordingly, would need drastic changes.

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GOVERNMENT POLICY FOR REMOVING UNEMPLOYMENT

Employment Policy upto the 1980s

Unemployment was recognised as a problem from the very beginning of the planning process in India. Accordingly, employment generation was accepted as a goal of development planning. However, ***a faster growth with special emphasis on employment-intensive sectors like the small-scale industry was considered adequate to generate employment of the order required to take care of the problem.***[26] For example, the Second Five Year Plan (1957-62) estimated a backlog of unemployment at 5 million and an annual addition of labour force at 1.5-2 million. It envisaged a rate of growth of 5 per cent per annum which was expected to generate employment opportunities for all of them over a period of 10 years. ***"Employment thus was treated as a goal of development, though not central, much less overarching.*** At the same time, it was also not treated purely as a 'residual'; some efforts were made to see that it remains an essential element of the development strategy."[27] Similar treatment of employment continued in the Third and Fourth Plans. However, achievements relating to growth of employment fell short of expectations. GDP growth rate averaged 3.5 per cent per annum, employment growth 2 per cent per annum, whereas labour force increased at a faster rate of 2.5 per cent per annum. As a result, the number of unemployed increased from about 5 million in 1956 to 10 million in 1973-74. This forced the planners to rethink their approach. To tackle the problem of increasing unemployment and persisting poverty (which was affecting almost one-half of India's population), ***the Fifth Five Year Plan (1974-79) envisaged a reorientation of development strategy towards an employment-oriented growth and introduction of special anti-poverty and employment programmes.***

The Planning Commission acknowledged in the Sixth Plan document the hard reality that despite economic planning, employment opportunities had not adequately increased over the years. The position was not satisfactory even in terms of long-term employment. Keeping in view these facts ***the employment policy under the Sixth Plan (1980-85) aimed at "the two major goals of reducing underemployment for the majority of labour force and cutting down on long-term unemployment".***[28] ***Obviously, for a lasting solution to these problems, employment-oriented rapid economic growth was necessary. Hence, efforts in this direction were combined with short-term measures which provided some relief at least on temporary basis.***

Since in our mixed capitalist economy private and cooperative sectors coexist with the public sector, the government committed itself to a policy of employment generation in all the sectors. It was admitted that production in the public sector is highly capital intensive and thus there was not much scope for creation of fresh employment in this sector. Therefore, ***the government decided to concentrate particularly on policy measures seeking to influence the private demand and utilisation of manpower in the private sector. This required emphasis on self-employment ventures in agriculture, cottage and small industries and allied activities as well as non-farm operations.*** Some of the major employment programmes thus undertaken were the Integrated Rural Development Programme (IRDP), the National Rural Employment Programme (NREP), the National Scheme of Training Rural Youth for Self-Employment (TRYSEM), the Operation Flood II Dairy Project and other dairy development schemes and Fish Farmers Development Agencies.

During the late 1970s and 1980s having recognised the fact that in Indian conditions the trickle-down effects of growth were not sufficient to generate the required employment opportunities, the need for supplemental employment programmes for specific target groups/areas was felt and as stated above under the Fifth and the Sixth Plans attempts were made in this direction. However, the magnitude of the unemployment problem continued to increase. Accordingly, the Seventh Five Year Plan (1985-90) for the first time sought to place employment at the centre of development strategy. The Planning Commission stated, ***"The central element in the development strategy of the Seventh Plan is the generation of productive employment."***[29] The Seventh Plan like some other earlier plans assigned a key role to the agricultural sector for employment generation. However, the agricultural sector cannot eliminate the entire unemployment backlog and also absorb additions to the labour force. Therefore, programmes of rural development, particularly those of rural capital formation in the form of construction were undertaken. The planners were clear that even the realisation of a high rate of industrial growth could not absorb more than a fraction of unemployed and underemployed labour force in the organised industrial sector.

According to the Planning Commission, employment generation does not necessarily imply creating wage employment. Under the Seventh Plan, there was considerable emphasis on creation of conditions for additional self-employment. Therefore, apart from sectoral programmes, ***the package of poverty alleviation programmes aimed at giving self-employment and wage employment to the poorer sections of the community*** (like NREP, RLEGP and IRDP)

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were continued. However, despite these efforts at providing employment, unemployment contained to increase and, as stated earlier, stood at 23 million as on April 1, 1992.

Employment Strategy During Post-Reform Period

It is often rightly argued that a high rate of economic growth is a necessary, but not a sufficient condition to solve the unemployment problem in India. In India, where employment elasticity is quite low, an annual growth rate of 8-9 per cent can provide only a partial solution to the unemployment problem. Raj Krishna had shown that on the assumption that population and productivity would continue to grow at the existing rates, the most comprehensive Daily Status unemployment could be eliminated in the next two decades if the long-term growth rate could rise to 6.5 per cent.[30] When Raj Krishna did his exercise, employment elasticity for all sectors was around 0.68. Since then employment elasticity has declined. It has been estimated to be 0.29 for 1993-94 to 2004-05 and 0.04 for 2004-05 to 2011-12. This implies that for generating additional employment at 3 per cent per annum, GDP should register an annual growth of 18-19 per cent which is something impossible in the given structure of the Indian economy. ***Therefore, in India, economic growth by itself can never solve the unemployment problem and the government policy which gives overriding priority to economic growth would add to unemployment backlog rather than reducing it.*** Therefore, under the Eighth Plan (1992-97) there was emphasis on both the growth of the economy and restructuring of output composition of growth. ***The Plan set a target of 2.6-2.8 per cent annual growth in employment with a view to achieving 'a near full employment situation' in a period of 10 years (i.e., by 2002).*** To achieve the target, the Plan advocated readjusting the sectoral composition of output in favour of sectors and sub-sectors having higher employment elasticity. It also advocated spatial and sub-sectoral diversification of agriculture, wasteland development, improving employment opportunities in the rural non-farm sector, promoting small and decentralised industrial sector, and faster growth of informal and service sectors. It also advocated changes in labour market policies.

The Ninth Five Year Plan (1997-2002) emphasised the need for providing productive work as it is a basic source of human dignity and self-respect. It is also an integral part in nurturing national identity and social cohesion. It also acknowledged the fact that in a labour-surplus economy like India, market forces alone cannot be relied upon to provide gainful work to all. Public intervention is necessary to ensure not only that adequate work opportunities are created, but also that the labour force is able to access these opportunities. As far as generating greater productive work opportunities is concerned, the plan emphasised ***"concentrating on sectors, sub-sectors and technologies which are more labour-intensive, in regions characterised by higher rates of unemployment and underemployment."***[31] However, as noted by Papola, in spite of pronouncing employment as a major dimension of State policy in the beginning, the Ninth Plan treated it as a ***residual*** resulting from growth rate and pattern determined by other factors and constraints rather than the consideration of employment generation.[32] Moreover, the plan projected growth of employment opportunities to be similar to that in the labour force, leaving the backlog of unemployment unchanged.

Despite the efforts at employment generation, the problem became more serious during the 1990s. The assumption that a higher growth rate will result in faster employment growth did not materialise. This would be clear from the fact that ***while GDP growth rate increased from 5.2 per cent during 1983-1993/94 to 6.7 per cent from 1993/94 to 1999/2000, the rate of employment growth actually declined from 2.7 per cent to 1.02 per cent per annum over the period.***[33] Employment elasticity of GDP growth correspondingly declined from 0.52 to 0.16 over the period. The backlog of unemployment at the start of Tenth Plan (2002-07) was estimated at 35 million. The addition to the labour force in this Plan was estimated at 36 million. The Plan argued that achievement of the targeted rate of growth of 8 per cent per annum would add 30 million person-years of employment while the policies advocated for employment generation in different sectors of the economy (particularly in agriculture and allied activities, small and medium enterprises, broad-based rural non-farm activities and some of the social service sectors like education and health) and appropriate policy changes for faster development of sectors of high labour intensity like construction, tourism, communication and information technology, and financial services would enable the addition of another 19.32 million person-years of employment. Thus, roughly 50 million person years of employment was planned to be generated over the Tenth Plan period[34] which would bring down the backlog of unemployment from around 35 million at the beginning of the Tenth Plan to roughly 21 million at the end of the Tenth Plan.

The Eleventh Five Year Plan (2007-12) aimed at creating 58 million job opportunities — about 17 million in trade, hotel and restaurant sector and about 12 million each in industry and construction (no increase in employment was projected in the agricultural sector).[35] The Plan advocated an employment strategy that could ensure rapid growth of employment and improvement in the quality of employment. The Plan argued that, "While self-employment will remain an important employment category in the foreseeable future

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— it accounted for 58 per cent of all employment in 2004-05 — there is need to increase the share of regular employees in total employment... It should be the focus of policy to achieve a substantial increase in the share of regular employment with a matching reduction in the share of casual employment which at present is as high as 23 per cent."[36] However, the Plan failed miserably in meeting the target of generating 58 million job opportunities.

Most of the observers agree that the post-economic reform period in India has witnessed the phenomenon of ***jobless growth***. The largest sector of the economy, agriculture, has witnessed lacklustre growth. The government's response in this context has been to aim at raising rural incomes through poverty alleviation programmes. However, the delivery of these programmes has not been satisfactory as there have been numerous 'leakages' due to corruption. The jobless from rural areas have been entering the 'informal' sector. It absorbs 92 per cent of the workforce and is characterised by unprotected jobs without regular salaries and engulfs a vast population of self-employed people and daily-wage workers. These workers also migrate to big cities and end up in slums in sub-human conditions.[37]

The Twelfth Five Year Plan hopes to make the manufacturing sector a genuine engine of growth, which could generate 100 million work opportunities by 2022.[38] The Plan notes that the employment contribution of labour-intensive manufacturing, namely textiles and garments, leather and footwear, gems and jewellery, food processing industries and so on can be greatly enhanced provided the government puts supportive policies in place. To reap the benefits from demographic dividend, the Plan also emphasises focusing on skill development which should "occupy centre-stage in any employment strategy for the Twelfth Plan".[39] The Plan proposes to create 50 million non-farm employment opportunities and provide skill certification to at least an equivalent number of people.[40]

MAJOR EMPLOYMENT PROGRAMMES

Swaranajayanti Gram Swarozgar Yojana (SGSY)/ NRLM was launched from April 1, 1999 after restructuring the IRDP and allied schemes. It is the only self-employment programme for the rural poor. The objective is to bring the self-employed above the poverty line by providing them income generating assets through bank credit and government subsidy. SGSY was restructured as National Rural Livelihoods Mission (NRLM), subsequently renamed as *Aajeevika* to implement it in a mission mode across the country. The programme was formally launched on June 3, 2011. NRLM is implemented through scheduled commercial banks (including RRBs). ***To begin with, NRLM will ensure that at least one member from each identified rural poor household, preferably a woman, is brought under the SHG (Self-Help Group) network in a time-bound manner.*** The scheme will further ensure that the poor are provided with requisite skills for managing their institutions, linking up with markets managing their existing livelihoods, and enhancing their credit absorption capacity and creditworthiness. NRLM will work towards achieving universal financial inclusion and is expected to reach all districts by the end of Twelfth Five Year Plan.

The Swarana Jayanti Shahari Rozgar Yojana (SJSRY) came into operation from December 1, 1997, subsuming the earlier urban poverty alleviation programmes, *viz.*, Nehru Rozgar Yojana, Prime Minister's Integrated Urban Poverty Eradication Programme and Urban Basic Services Programme. The programme was revamped with effect from April 1, 2009. The scheme provides gainful employment to the urban unemployed and underemployed poor, by encouraging the setting up of self-employment ventures by the urban poor and also by providing wage employment and utilising their labour for construction of socially and economically useful public assets. The revamped SJSRY has five components: (*i*) the Urban Self-Employment Programme, (*ii*) the Urban Women Self-Help Programme, (*iii*) Skill Training for Employment Promotion among Urban Poor, (*iv*) the Urban Wage Employment Programme, and (*v*) the Urban Community Development Network.

Prime Minister's Rozgar Yojana (PMRY) was designed to provide self-employment to more than a million educated unemployed youth by setting up of seven lakh micro-enterprises under the Eighth Five Year Plan. During the Eighth Plan, while loans in 7.70 lakh cases were sanctioned, the actual disbursement of loans was in 5.76 lakh cases. The scheme was continued in the Ninth Five Year Plan. In the first three years of the Ninth Plan, loans were disbursed in 5.0 lakh cases which provided employment to 7.4 lakh persons.

The National Rural Employment Programme (NREP) was started as part of the Sixth Plan and was continued under the Seventh Plan. On April 1, 1989, it was merged into the Jawahar Rozgar Yojana. The NREP was meant to help that segment of rural population which largely depends on wage employment and has virtually no source of income during the lean agricultural period. Under the NREP, development projects and target group-oriented employment generation projects were closely intertwined. The programme was implemented as a centrally-sponsored scheme. But its financial burden was to be shared between the Central government and the State governments on 50:50

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basis. Under the scheme a district level employment plan (disaggregated block-wise) was prepared.

The Rural Landless Employment Guarantee Programme (RLEGP) was started on 15th August, 1983, with the objective of expanding employment opportunities for the rural landless. The programme aimed at providing guarantee of employment to at least one member of the landless household for about 100 days in a year. Under this scheme, infrastructural development was undertaken with a view to creating employment opportunities for the rural landless. Though the programme was to be fully financed by the Central government, the implementation of the programme was entrusted to the States.

The Integrated Rural Development Programme (IRDP) launched in 1978-79 and extended all over the country in 1980-81 was essentially conceived as an anti-poverty programme under the Sixth Five Year Plan. It, however, through a programme of asset endowment, also meant to provide self-employment in a variety of activities like sericulture, animal husbandry and land-based activities in the primary sector; weaving, handicrafts, etc., in the secondary sector; and service and business activities in the tertiary sector. Under the Sixth Plan, the IRDP aimed at covering 15 million families in all the blocks of the country. Thus, on an average, about 3,000 families in a block were expected to receive assistance under this programme. The assets provided to these households were financed through a mix of government subsidy and institutional credit on an average subsidy-credit ratio of 1:2. Under the IRDP, 382 million families were assisted. However, the exact amount of employment generated has not been estimated.

The Scheme of Training Rural Youth for Self-employment (TRYSEM) was initiated in 1979 with the objective of tackling unemployment problem among the rural youth. It aimed at training about 2 lakh rural youths every year to enable them to become self-employed. Under this scheme 40 youths were to be selected from each block and for being eligible for selection, the person was required to belong to a rural family having an income less than ₹ 3,500 per year. In making selection, members of scheduled castes and scheduled tribes were given preference. Under the scheme, a minimum of one third of the rural youths trained were to be women. The TRYSEM was merged into Swarnajayanti Gram Swarozgar Yojana in April 1999.

Jawahar Rozgar Yojana (JRY). In February 1989 the government announced a new wage employment scheme, the Jawahar Lal Nehru Rozgar Yojana for intensive employment creation in 120 backward districts. However, later on it was felt that there was no need to have the separate NREP, RLEGP and the Jawahar Lal Nehru Rozgar Yojana. These wage employment programmes had the same objective and similar thrust. Therefore, these programmes were merged into a single rural employment programme on April 1, 1989 and it was given the name ***Jawahar Rozgar Yojana (JRY)***.

The JRY completed eleven years in March 1999. The JRY was restructured with effect from April 1999 and was renamed as ***Jawahar Gram Samridhi Yojana (JGSY)***. In the first ten years the JRY generated 7,373 million mandays of employment. Thus, in quantitative terms, the performance of the JRY was not distinctly better than that of the NREP and RLEGP. However, in two respects the JRY was superior to the NREP/RLEGP regime. First, under the JRY there was a clear change in the priorities in favour of economically productive investments, especially which enhance the productivity of land. Second, the JRY approach involving panchayats in planning and implementation of employment schemes was superior to the bureaucratic approach followed under the NREP/RLEGP.

The objective of JGSY was creation of infrastructure and durable assets at the village level so as to increase opportunities for sustained employment to the rural poor. The wage employment under JGSY was provided normally to persons belonging to households below poverty line. There was no sectoral earmarking of resources under JGSY. However, 22.5 per cent of annual allocation had to be spent on schemes for the benefit of Scheduled Castes/Scheduled Tribes and 3 per cent of annual allocation was to be utilised for creation of barrier free infrastructure for the disabled.

The Employment Assurance Scheme (EAS). The EAS aimed at providing 100 days of unskilled manual work on demand to two members of a rural family in the age group of 18 to 60 years in the agricultural lean season within the blocks covered under the scheme. The EAS was universalised so as to make it applicable to all the rural blocks of the country.

MAHATMA GANDHI NATIONAL RURAL EMPLOYMENT GUARANTEE SCHEME (MGNREGS)

Rural unemployment has sharply accentuated in India in the recent years. Between 1993-94 and 1999-2000 rural employment grew at the annual rate of 0.58 per cent while the rate of growth of rural labour force was much higher. In the absence of gainful employment opportunities in rural areas, an increasing number of rural households have faced complete collapse of their incomes. This miserable plight of the rural households has driven an unprecedented number of farmers to commit suicide. Recognising this humanitarian

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crisis, the government of the United Progressive Alliance (UPA) at the Centre made a commitment in its Common Minimum Programme (CMP) that it would immediately enact an Employment Guarantee Act. ***The draft proposed by the National Advisory Council (NAC) envisaged legal guarantee to every household in rural areas for 100 days for doing casual manual work.***

National Rural Employment Guarantee Act (NREGA)

The National Rural Employment Guarantee Act (NREGA) was enacted in September 2005. It came into force on February 2, 2006 and was implemented in a phased manner. In Phase I, it was introduced in 200 of the most backward districts of the country. It was implemented in an additional 130 districts in 2007-08 under Phase II. As per the initial target, NREGA was to be expanded countrywide in five years. However, in order to bring the whole nation under its safety net and keeping in view the demand, the scheme was extended to the remaining 274 rural districts of India from April 1, 2008 in Phase III. Thus, ***National Rural Employment Guarantee Act (NREGA) now covers all rural areas of the country. From October 2, 2009, National Rural Employment Guarantee Scheme (NREGS) has been renamed as Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS).***

Features of MGNREGS

MGNREGS seeks to provide at least 100 days of guaranteed wage employment in a financial year to at least one member of every rural household whose adult members volunteer to do unskilled manual work. Thus, MGNREGS is different from other wage employment programmes as it bestows a legal right and guarantee to the rural population through an Act of Parliament and is not just a scheme like other wage employment programmes. With its rights-based framework and demand-driven approach, MGNREGS marks a paradigm shift from the previous wage programmes. Unique features of the scheme include, time bound employment guarantee and wage payment within 15 days, incentive-disincentive structure to the State governments for providing employment as 90 per cent of the cost of employment provided is borne by the Centre or payment of unemployment allowance at their own cost, and emphasis on labour-intensive works prohibiting the use of contractors and machinery. ***At least 33 per cent of the beneficiaries are to be women.*** Under MGNREGS, wage disbursement through bank and post office accounts is mandatory. This is likely to help in the 'financial inclusion' of the poor.

The focus of MGNREGS is on works relating to water conservation, drought proofing (including afforestation/tree plantation), land development, flood control/protection (including drainage in waterlogged areas) and rural connectivity in terms of all weather roads. Panchayats have a key role in planning, implementation and monitoring of MGNREGS through preparation of perspective plan, approval of shelf of projects, and execution of works at least to the extent of 50 per cent in terms of costs. This shows that ***the Act is also a significant vehicle for strengthening decentralisation and deepening the grass root democratic structure.***

MGNREGS promised a wage rate of ₹ 100 per day to a worker. However, with time, wages in many States fell below the minimum wages. Moreover, rising food prices made it very difficult to make two ends meet. Accordingly, from January 2011, the government revised the wages by linking them to the Consumer Price Index for Agricultural Labour (CPI-AL) for each individual State. Accordingly, wages paid under MGNREGS have increased between 17 to 30 per cent in different States depending upon the trend in CPI-AL.

Total expenditure under MGNREGS in 2015-16 was ₹ 44,002 crore which shot up to ₹ 58,525 crore in 2016-17.

Implementation of MGNREGS

MGNREGA completed twelve years of its existence on February 2, 2018. ***It is the first ever law internationally that guarantees wage employment at an unprecedented rate.*** UNDP in its *Human Development Report* 2015 mentions MGNREGS as a 'milestone' and hails it as the 'best known' employment guarantee scheme providing direct employment to the rural poor.[41] The main achievements of MGNREGS are as under:

1. **Increasing employment opportunities:** In the first year of implementation (2006-07) in 200 districts, 2.10 crore households were employed and 90.5 crore person- days of employment[42] was generated. In 2015-16, 235 crore person-days and in 2016-17, 236 crore person-days of employment was generated.
2. **Enhancing wage earning and impact on minimum wages:** The enhanced wage earnings have led to the strengthening of the livelihood resource base of the rural poor in India. This would be clear from the fact that more than 70 per cent of total expenditure under MGNREGS since its inception has been on wages. In 2016-17, the share of wages in total expenditure under MGNREGS was 70 per cent (₹ 40,787 crore out of ₹ 58,525 crore).

   As far as impact on wages is concerned, the average wage paid under MGNREGS increased from ₹ 65 in 2006-07 to ₹ 132.7 in 2013-14 and further to ₹ 161.65 in 2016-17. This had helped in increasing the bargaining power of agricultural labour and even

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private sector wages have increased. In their study on the impact of MGNREGS on rural and urban labour markets, Clement Imbert and John Papp have found that work on the programme reduced labour supply to private sector in rural areas (thus pushing up the wages of casual workers employed by private sector employers in rural areas) and also reduced migration to urban areas (thus pushing up wages for seasonal migrants from rural areas to urban areas).[43]

3. **Increasing outreach to the disadvantaged groups:** Self targeting in nature, MGNERGS has high works participation of marginalised groups like SCs/STs and women. The share of SCs, STs and women over the ten year period 2006-2016 has been about 20 per cent, 17 per cent and 57 per cent respectively (it was 21.3 per cent for SCs, 17.6 per cent for STs and 56.2 per cent for women in 2016-17). As stated earlier, the Act targeted that 33 per cent (i.e., one-third) of the beneficiaries have to be women. The actual achievement of about 57 per cent is, thus, much higher than the target. This large women participation should help ***women empowerment.***
4. **Financial inclusion:** The Central government has been encouraging the State governments to make wage payments through bank and post office accounts of wage seekers. The Ministry is also encouraging the MGNREGA workers to obtain insurance under Jan Shri Yojana of LIC.
5. **Strengthening natural resource base of the economy:** With the purpose of strengthening the natural resource base of the economy, MGNREGS has focused primarily on works relating to soil and water conservation, land development and afforestation, all of which address the causes of degradation of natural resources. Such works lead to the creation of durable assets. MGNREGA works have led to enhanced productivity and regeneration of the natural resource base, further strengthening its potential for generating environmental benefits. In addition, soil conservation, fodder development, afforestation, and drought proofing works have sequestered carbon, thus mitigating climate change.[44]

Social Inclusion under MGNREGS

As noted by C.P. Chandrasekhar and Jayati Ghosh, "The NREGS is necessarily 'inclusive' at the most basic level in economic terms, because it self targets those who are willing to engage in arduous physical work for a daily wage, in other words, the poorest sections of society. But it is also emerging that ***the MGNREGS tends to be more socially inclusive as well, that is, it disproportionately involves women, SCs and STs as workers in the scheme.***"[45] As noted by Chandrasekhar and Ghosh, the impressive participation of women in MGNREGS is a harbinger of social change. It is also likely to lead to decline in distress migration and improvement in food consumption among certain families. In a similar way, the social inclusion of the economically marginalised groups in India (SCs/STs) is likely to improve considerably as their participation in MGNREGS has been quite impressive. Linking of the wage delivery mechanism to the opening of post office or bank accounts is also likely to improve social inclusion through the medium of financial inclusion.

Criticisms of MGNREGS

MGNREGS has been criticised on a number of counts. The main criticisms are as follows:

1. **Loss of momentum:** MGNREGS has been losing momentum in recent times. Employment generation has hit a downtrend, with the biggest declines being registered for the marginalised sections like scheduled castes and scheduled tribes. From a peak level of 54 person-days of employment per household in 2009-10, this flagship scheme could generate only 46 person-days of employment in 2016-17. In fact, data for the last four years (2013-14 to 2016-17) show that the government was able to provide just 45 days of employment on an average.

   The MGNREGS law guarantees 100 days of employment in a year. ***However, of the 5.12 crore households that were provided employment under MGNREGS in 2016-17, only 3.99 million (i.e., just 7.8 per cent) could be provided at least 100 days of employment.***
2. **Irregularities in implementation:** There are widespread irregularities in implementation and bribes and paybacks are common. For instance, a CAG (Comptroller and Auditor General) Report (2007) on MGNREGA pointed out that in Bihar, ₹ 8.99 lakh was paid as wages to fictitious labour in respect of 7 works, as the name of the same labourer was recorded twice or thrice for the same period in the same or other muster rolls.[46]
3. **Tampering of muster rolls:** There is considerable tampering of muster rolls by using white fluid and marking absent as present and also overwriting the number of days worked. In some cases, names of those workers were found on the muster rolls who had long migrated to other places. Moreover, names of dead persons have also been found on the muster rolls.[47]

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4. **Widespread corruption:** Surveys carried out by different researchers/organisations and some social audits have revealed widespread corruption under MGNREGS. Instances of fake and handwritten bills, exaggerated claims, use of substandard materials and funds swindled by village heads, officials, etc. galore. For example, an estimate of corruption under MGNREGA in Rajasthan in 2009-10 shows that "***roughly a third of the funds allocated for material purchases was being used to line the pockets of a long chain of people*** – from the sarpanchs, gram sevaks and sachivs (secretaries) at the lowest rung through civil engineers, accountants, contractors, dealers and suppliers to BDOs, going right upto the District Collector in a few cases."[48] Beneficiaries have to shell out bribes even to get their wages. For instance, a survey conducted recently by NCAER shows that 67 per cent people covered under the survey had to 'share' their guaranteed wage.[49]

5. **Delayed payments of wages:** There are reports from various States pointing towards delayed payments of wages beyond the stipulated period of 15 days. The delay in wage payment was 39 per cent in 2012-13 which rose to as high as 54 per cent in 2013-14 and further to as high as 72 per cent in 2014-15. In 2016-17, ₹ 19,455 crore worth of wages were paid after the stipulated 15 days. This was 55.9 per cent of the total wages paid in that year.

   As stated earlier, MGNREGA says that wages should be paid to workers within 15 days of the generation of muster roll. If that is not done, the workers need to be paid compensation for each day of delay till the wages are deposited into their accounts. However, the government has in place regulations that systematically calculate less than the payable compensation and even this is not paid. For the year 2016-17, government records show that ₹ 441 crore worth of compensation (calculated using the method that understates the demand) was due to workers for delayed wages. However, the government approved compensation of only ₹ 17.5 crore.[50]

6. **Declining share of wages:** There is evidence that in many gram panchayats, the proportion spent on labour wages is declining at a fast rate. The trends of declining labour component in MGNREGS seriously undermine the very promise of the job guarantee programme.

7. **Lack of staff:** Lack of dedicated administrative and technical staff for MGNREGS has become a key constraint responsible for procedural lapses. Appointments of 'programme officer' and 'gram rozgar sevaks' have not been carried out in some States. "Staff shortages have become a common excuse for non-compliance with the guidelines."[51]

8. **Non-payment of unemployment allowance:** As noted earlier, under the stipulations of the Act, the State government is responsible for the payment of the unemployment allowance. This provision is intended as an incentive to the States to provide employment since the Central Government bears 90 per cent of the cost of employment. However, a number of State governments have either shown reluctance to disburse unemployment allowance or have tried to effectively scuttle it. As pointed out recently by Reetika Khera, most people do not know about this provision and wait for MGNREGS work to open in their villages, which in turn depends on supply of funds. This has turned the scheme upside down from being demand (for jobs) driven to supply (of funds) driven.[52] There have been very few cases of payment of unemployment allowance.

   Despite inordinate delay in payment of wages and non-payment of unemployment allowance, not a single worker has gone to Court to claim his or her right under the Act. Thus, the problem of low accountability of the government remains. According to Jean Dreze, ***"This fundamental issue of low accountability, and its multiple manifestations, continue to haunt NREGA today."***[53] In addition, the growing centralisation and complexity of NREGA are creating their own problems.

Conclusion

However, as can be easily seen, most of the criticisms of MGNREGS given above pertain to inefficiencies of implementation. The rationale of the scheme itself is not in doubt. Many observers agree that MGNREGS has the potential to transform rural economic and social relations at many levels. Field reports suggest a growing sense of entitlement among the deprived. According to C.P. Chandrasekhar and Jayati Ghosh, "The programme reverses the way the Indian State has traditionally dealt with the citizenry, and envisages a complete change in the manner of interaction of the State, the local power elites and the local working classes in rural India. The MGNREGS is therefore completely different in conception from earlier government employment schemes since it treats employment as a right and the programme is intended to be demand-driven."[54] Moreover, MGNREGA calls for substantial participation of the local people in the planning and monitoring of the specific schemes, to a degree which has not been at all common. In a recent review of MGNREGS,

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Ashok Pankaj has opined that this programme has revitalised the panchayati raj institutions. The dormant gram sabha has become active. In some places, social audits have taken place. The importance of the gram panchayat as an institution has increased so much so that the election for the post of gram panchayat head has become highly competitive. This bodes well for the growth of grassroots democracy in the country.[55]

According to Chandrasekhar and Ghosh, the 'inclusive' form of public spending under the MGNREGS is not only desirable from a social or welfare perspective; it is justified on economic grounds also. By providing wage income directly to unskilled workers and in rural areas, it helps in increasing aggregate demand substantially because of the high value of multiplier in such expenditure. This, in turn, acts as a ***macroeconomic weapon against slump.***

While the continuation of MGNREGS is desirable on account of the above reasons, it is necessary to tackle the problems relating to inefficiencies in the implementation of the scheme. This calls for a drastic overhaul of the scheme with greater transparency and accountability through social audits.

RETHINKING THE EMPLOYMENT STRATEGY: FOCUS ON MANUFACTURING

We have discussed earlier in this chapter the problem of jobless growth (and in recent three years, the problem of job loss growth). This requires immediate attention as the problem of unemployment is bound to get more difficult as more and more people continue to join the labour force in the coming years. The scale of the employment challenge that India faces would be clear from the following conclusions of a study conducted by Sudipto Mundle, "India's core labour force, estimated at about 430 million, is growing 1.5 per cent annually, which means it will add six to eight million young workers each year over the next decade or so. In addition, there are around 13 million openly unemployed, 52 million underemployed and another 52 million, mostly women, who are not in the labour force due to lack of adequate opportunities. In other words, there is a backlog of 117 million people. If this backlog is to be cleared over the next 15 years and the new entrants joining the labour force every year are to find employment, ***India will need to add 15 million new jobs annually***".[56] In this context, it would be pertinent to note the results of *Asia-Pacific Human Development Report* 2016 (published by United Nations Development Programme) released on April 27, 2016 which states that between 1991 and 2013, the size of India's 'working age' population increased by 300 million of which only 140 million could be provided jobs. ***This suggests India's limited capacity to generate jobs.*** The Report estimates that by 2050, at least 280 million more people will enter the job market in India. India's population in the working age (15-64 years) is expected to be more than 1 billion by 2050.

The above data and the fact that India could provide employment to less than half to the entrants in the job market during the period 1991 to 2013 clearly bring out the employment challenge that India faces today. According to some observers, the failure to create adequate jobs in India *vis-a-vis* the requirements over the period 1991 to 2013 stems from the 'nature of growth' that the Indian economy experienced. It was mostly services-led growth with low employment intensity. As emphasized by Ajit K. Ghose, meeting the employment challenge requires a reorientation of India's growth strategy. ***It requires organised manufacturing to become the engine of growth for India's economy***. In this context, one can visualise two scenarios: the first focusing on the external demand (i.e., export market) and the second focusing on the internal demand (i.e., the domestic market). Ajit K. Ghose opines that it is not possible to visualise exports driving growth of organised manufacturing in India today as they did in the Republic of Korea or China in the recent past. This is not to say that exports will not be important; only that export growth alone will not deliver the kind of rapid growth of organised manufacturing that India needs. The focus will have to be on domestic market. In this context, policies will need to keep two central objectives in view: (1) achieving rapid growth of agriculture, and (2) creation of an integrated national market.[57] In addition to these factors operating from the demand side, it will also be necessary to remove constraints. However, meeting the employment challenge will require not just high growth of organised manufacturing but also high employment elasticity in the sector.

Expanding the Domestic Market. As noted above, expanding the domestic market will require twin policies of achieving rapid growth in agriculture and the creation of an integrated national market. As far as the former is concerned, it needs to be emphasised that a rapid growth in agriculture is required to bring rapid expansion of domestic demand for manufactures. Since the agricultural sector in India has been witnessing a virtual stagnation for most of the period in recent years, demand for manufactured goods has remained quite limited. Therefore, policies need to be devised to accelerate growth in agriculture. These include increasing public investment in infrastructure (irrigation and water management systems, cold storage networks, rural roads, etc.); extending green revolution to eastern States; promoting

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shifts to non-cereal products (fruits and vegetables, fisheries, animal husbandry); promoting agro-processing industries; and reforming markets in agricultural products.

As far as the issue of creation of an integrated national market is concerned, it needs to be pointed out that presently there is a non-existence of national markets in both agriculture and industry. There is no national market in agriculture products because markets in these products are regulated under the Agricultural Produce Market Committee (APMC) Acts enacted by the State governments, which stipulate that the first sale of agricultural products produced in the region must be conducted in the regulated markets of the region. In the case of industrial products, there is no national market because of the simultaneous existence of Central and Sales taxes. Hence, promotion of an integrated national market will require action on two fronts. The first includes reform (and perhaps eventual abolition) of the APMC Acts, developments of farmers' markets, development of agro-processing industries, and expansion of private wholesale trade. The second is replacement of the Central and State taxes by a well designed goods and services tax (GST) regime[58] (this process, as we all know, is already underway).

Removing Supply-side Constraints. The most important supply-side constraint on the manufacturing sector is inadequate and poor quality physical infrastructure (fuel and power supply, transport networks, and ports and airports). Most enterprise surveys show that the entrepreneurs perceive this constraint to be the most important constraint. Enterprise surveys also list the poor quality of the business regulatory environment as an important supply-side constraint. Another constraint highlighted by some observers is the domestic tax regime that discriminates against manufacturing *vis-a-vis* services. Inadequate availability of skilled manpower also becomes a constraint on the manufacturing sector. Realising the full potential of the manufacturing sector will require the removing of all such supply-side constraints.

Ensuring High Employment Elasticity. Meeting the employment challenge will require not just high growth of organised manufacturing, but also high employment elasticity in the sector. In this respect, there is a need to focus on employment-intensive industries like textiles, leather, metals, automobiles, gems and jewellery, transport, handloom sector, etc. A strategy has also to be devised to push up the growth of small scale industries at a faster pace, as it is frequently observed that these industries are relatively more labour-intensive as compared with the large scale industries. It will also be necessary to focus on policies that make the unemployed employable. For this purpose, it is necessary to pay more attention to basic education which is the essential foundation for skill development. As noted by Mundle, "In the absence of reforms in primary and basic education, India's awesome backlog of unemployment will continue to grow. The possible consequences for social tensions and political strife are frightening".[59]

APPENDIX I TO CHAPTER 12

NATIONAL POLICY FOR SKILL DEVELOPMENT AND ENTREPRENEURSHIP 2015

The Background

Skills and knowledge are driving forces of economic growth and social development for any country. Countries with higher levels and better standards of skills adjust more effectively to the challenges and opportunities in domestic and international job markets. The first National Policy on Skill Development was notified in 2009. In the aftermath of this policy, National Skill Development Corporation (NSDC) was established in 2009 to promote private sector participation via innovative funding models. NSDC has tied up with more than 211 training providers, many of whom have started scaling up their operations, to offer short-term training programmes. They also supported and incubated 37 Sector Skills Councils (SSCs) which are intended to facilitate much needed participation and ownership of industry to ensure needs based training programmes. National Skills Development Agency (NSDA) which was created in June 2013 has been working with State governments to rejuvenate and synergise skilling efforts in the States. National Skills Qualification Framework (NSQF) will facilitate increased adoption of skill development programmes, with availability of pathways for progression between higher education and skill development. These efforts build on the legacy vocational training infrastructure of Industrial Training Institutes (ITIs) and polytechnics which have now grown in number to approximately 12,000 and 3,200 respectively.

However, ***the country has a big challenge ahead as it is estimated that only 4.69 per cent of the total workforce in India has undergone formal skill training*** as compared to 68 per cent in UK, 75 per cent in Germany, 52 per cent in USA, 80 per cent in Japan, and 96 per cent in South Korea. On demand side, a skill gap study has been conducted by NSDC over 2010-2014, which indicates that ***there is an additional net incremental requirement of 109.73 million skilled manpower by 2022 in 24 key sectors.***[60]

Aims and Objectives of the Policy

The vision of 'National Policy for Skill Development and Entrepreneurship 2015' is "to create an ecosystem of empowerment by skilling on a large scale at speed with high standards and to promote a culture of innovation based

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entrepreneurship which can generate wealth and employment so as to ensure sustainable livelihoods for all citizens in the country".

The core objective of the Policy is to empower the individual, by enabling him/her to realize their full potential through a process of lifelong learning where competencies are accumulated via instruments such as credible certifications, credit accumulation and transfer, etc. As individuals grow, the society and nation also benefit from their productivity and growth. This will involve: *(i)* focus on an outcome-based approach towards quality skilling that on one hand results in increased employability and better livelihoods for individuals, and on the other hand translates into improved productivity across primary, secondary and tertiary sectors; *(ii)* increase the capacity and quality of training infrastructure and trainers to ensure equitable and easy access to every citizen; *(iii)* ensure both vertical and horizontal pathways to skilled workforce for further growth by providing seamless integration of skill training with formal education; *(iv)* address human resource needs by aligning supply of skilled workers with sectoral requirements of industry and the country's strategic priorities including flagship programmes like Make in India; *(v)* establish an IT based information system for aggregating demand and supply of skilled workforce which can help in matching and connecting supply with demand; *(vi)* recognise the value of on-the-job training, by making apprenticeships in actual work environments an integral part of all skill development efforts; *(vii)* ensure that the skilling needs of the socially and geographically disadvantaged and marginalised groups (like the SCs, STs, OBCs, minorities, differently abled persons, etc.) are appropriately taken care of; *(viii)* promote increased participation of women in the workforce through appropriate skilling and gender mainstreaming of training; and *(ix)* promote commitment and ownership of all stakeholders towards skill development and create an effective coordination mechanism.

The core objective of the entrepreneurship framework is to coordinate and strengthen factors essential for growth of entrepreneurship across the country. This would include: *(i)* promote entrepreneurship culture and make it aspirational; *(ii)* encourage entrepreneurship as a viable career option through advocacy; *(iii)* integrate entrepreneurship education in the formal education system; *(iv)* ensure ease of doing business by reducing entry and exit barriers; *(v)* facilitate access to finance through credit and market linkages; *(vi)* promote entrepreneurship among women; and *(vii)* broaden the base of entrepreneurial supply by meeting specific needs of both socially and geographically disadvantaged sections of society including SCs, STs, OBCs, minorities and differently-abled persons.

Measures for Skill Development

'National Policy for Skill Development and Entrepreneurship 2015' outlines a number of measures for skill development. Some of these measures are as follows:

1. Skilling will be integrated with formal education by introducing vocational training classes linked to the local economy from class nine onwards in at least 25 per cent of the schools, over the next five years.
2. National Skills Universities and institutes will be promoted in partnership with States as Centres of excellence for skill development and training of trainers, either as de-novo-institutions or as a part of existing university landscape.
3. Skilling will be increasingly integrated with higher education with polytechnics offering NSQF aligned vocational courses and Bachelor of Vocational Studies degrees.
4. The existing ITIs and Polytechnics will be modernized with courses and curriculum that are aligned to the emerging competency based demand in the market.
5. India has a tremendous amount of hard and soft infrastructure which is underutilised. For instance, there are over 10 lakh institutional buildings that are used for less than 40 hours a week. Their capacity will be used during holidays/off hours for training purposes.
6. New ITIs will be set up in PPP mode especially in unserved blocks of the country to expand outreach of skilling programmes.
7. State governments would be encouraged to set up Kaushal Vardhan Kendras (KVKs) at panchayat level for mobilising and imparting skills pertaining to local employment/livelihood opportunities to school dropouts, adolescent girls, housewives and rural youth.
8. The human resource requirements of the country will be addressed by aligning the supply and composition of skilled workers with demand.
9. A Quality Assurance (QA) framework embedded in NSQF will be finalised. This will build trust and confidence in the system by putting in place mechanisms that ensure the qualifications (and related training) produce consistent quality outcomes, and are relevant to the labour market.
10. All formal and vocational education including skill training will have to align themselves with NSQF by December 2018. A legal framework to support NSQF will also be put in place.
11. Sector Skill Councils (SSCs), as industry-led bodies, will be strengthened by making them more

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representative, expanding their outreach and increasing their efficiency. Development of standards by SSCs will be under the aegis of National Skills Qualification Committee (NSQC) under NSQF.

12. All skill training programmes shall include basic modules of computer literacy, finance, language and soft skills like etiquettes, appreciating gender diversity in workplace, building positive health attitudes, social and life skills to enable the youth to be employable and market ready.
13. A national Labour Market Information System (LMIS) will be created. This will be an integrated database, which contains socio-economic data in modules on: *(i)* supply-side skilled labour force statistics, *(ii)* demand of skilled/unskilled labour, *(iii)* market trends like wage structures and distribution, economic manpower, occupational shortages, etc.
14. **Skill India and Make in India.** Make in India and Skill India are complementary to each other. ***The key objective of Make in India is to promote manufacturing in 25 sectors of the economy, which will lead to job creation and consequently need for skilled manpower.*** Some of these sectors are automobiles, chemicals, IT, pharmaceuticals, textiles, ports, aviation, leather, tourism and hospitality, wellness, railways, auto components, design manufacturing, renewable energy, mining, bio-technology and electronics. Correspondingly, ***Skill India aims at preparing a highly skilled workforce which is completely aligned to the requirements of industry so as to promote growth through improved productivity.***

    Skilling efforts will be completely aligned with the requirements of 25 key identified sectors of Make in India. A joint committee of stakeholders under both initiatives will be constituted to closely monitor growth of manufacturing activity under Make in India programme and anticipate skill requirements for such initiatives so that the same can be developed in coordination with various SSCs (Sector Skill Councils) and training institutions.
15. Promotion of only brick and mortar facilities will not ensure the speed and scale desired to transform the skill development efforts. The use of technology will be leveraged to scale up training facilities, enable access to remote areas and increase cost-effectiveness of delivery of vocational training.
16. Entrepreneurship education will be integrated into the mainstream curriculum in 3,000 colleges across India. These colleges will also be provided with additional support and retraining of existing faculty to deliver entrepreneurship courses to enrolled students from all tracks and courses.
17. One national, 30 State, 50 Nodal and 3,000 college based E-hubs (Entrepreneurial Hubs) will be set up to deliver support. These E-Hubs will, collectively, cover the entire nation.

Governance Structure

1. Ministry of Skill Development and Entrepreneurship (MSDE) has been created to fulfill the vision of a 'Skilled India' where human resource development is the primary focus. MSDE will be responsible for coordination with all concerned for evolving an appropriate skill development framework, removal of disconnect between demand for, and supply of, skilled manpower, skill upgradation, building of new skills, innovative thinking and talents for existing and future jobs. ***MSDE will also play the lead role in ensuring the implementation of the National Policy for Skill Development and Entrepreneurship 2015.***

2. National Skill Development Agency (NSDA) was set up as a Society in June 2013. NSDA will focus on the two verticals of Quality Assurance and policy research in the skills space. It will be responsible for the operationalisation and implementation of NSQF.

3. National Skill Development Corporation (NSDC), a Public Private Partnership was set up in 2008 with a 49 per cent shareholding of Government of India and a 51 per cent shareholding of the private sector. It will be the model organisation for all private sector initiatives in the short-term skilling space.

4. In order to ensure that skill development efforts being made by all stakeholders in the system are in accordance with the actual needs of the industry, Sector Skill Councils (SSCs) are being set up. SSCs are industry-led and industry-governed bodies, which will help link the requirements of industry with appropriately trained manpower.

Financing

Public funds (comprised of funding by Central government, State government and grant based schemes) are finite and will not be able to cover the magnitude of the challenge of Skilling India, hence alternative sources of funds are required. Therefore, all stakeholders, the government both at Centre and States, the enterprise – public and private, and the direct beneficiary – the individual, would contribute in mobilizing financial or in-kind resources for skill development.

National Skill Development Fund (NSDF) has been set up by Government of India with the objective of encouraging skill development in the country. A public

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Trust set up by Government of India is the custodian of the Fund. The Fund acts as a receptacle for all donations, contribution in cash or kind from all contributors (including government, multilateral organisations, corporations, etc.) for furtherance of the objectives of the Fund.

A Credit Guarantee Fund for skill development and a National Credit Guarantee Trustee Company (NCGTC) has been set up to support the initiative of loans for the purpose of skilling and will be used to leverage credit financing in the skill landscape. It will be further expanded to ensure greater outreach and access to all citizens. Similarly, a Credit Guarantee Fund for Entrepreneurship Development worth ₹ 3,000 crore per year has already been initiated under Prime Minister MUDRA Yojana through NCGTC.

APPENDIX II TO CHAPTER 12

PRADHAN MANTRI KAUSHAL VIKAS YOJANA

Currently, only a very small proportion of India's workforce has any formal skill training. Not surprisingly, therefore, several sectors of the country's economy face shortage of skilled people and are mired with low productivity levels due to poor quality of workforce. According to recently established National Skill Development Council (NSDC), there is a severe quality gap and lack of availability of trainers in the vocational education and training sector. By 2017, this skill gap within the vocational training sector including both teachers and non-teachers will reach a figure of 2,11,000. The workforce requirement is projected to increase to 3,20,000 by 2022.[61] Government has to invest in bridging the skill gap in the vocational education and training sector to improve the employability of people. In this context, skill development has become a key priority area for the country. It is in this background that the Pradhan Mantri Kaushal Vikas Yojana (PMKVY) has been launched. It is the flagship outcome-based skill training scheme of the new Ministry of Skill Development and Entrepreneurship (MSDE). It is being implemented by the National Skill Development Council (NSDC).

Objectives

The objective of this scheme is to encourage skill development for youth by providing monetary rewards for successful completion of approved training programmes. Specifically, the Scheme aims to:

1. Encourage standardisation in the certification process and initiate a process of creating a registry of skills.
2. Enable and mobilise a large number of Indian youth to take up skill training and become employable and earn their livelihood, increase productivity of the existing workforce and align the training and certification to the needs of the country.
3. Provide Monetary Awards for Skill Certification to boost employability and productivity of youth by incentivizing them for skill training.
4. Reward candidates undergoing skill training by authorised institutions at an average monetary reward of ₹ 8,000 per candidate.
5. ***Benefit 24 lakh youth at an approximate total cost of ₹ 1,500 crore.***

Strategy and Approach

PMKVY will provide monetary incentives for successful completion of market-driven skill training and certification to approximately 24 lakh youth in a span of one year from the date of implementation of the scheme. This scheme shall be implemented through Public-Private and Public-Public partnerships. The implementing agency of PMKVY is the National Skill Development Corporation (NSDC). Under the scheme, monetary reward would be provided to trainees who are successfully trained, assessed and certified in skill courses run by affiliated training providers. This will boost the productivity of the country's workforce by enabling them to acquire high quality skill training across a range of sectors. It will also bring about a paradigm shift from input-based to outcome-based skill training in the country. It also seeks to significantly scale up skill training activities in the country and enable skill training to happen at a fast pace without compromising quality. Institutional arrangements comprising of the National Skill Development Council (NSDC), Sector Skill Councils (SSCs), Assessing Agencies and Training Partners are already in place for implementation of the scheme.

Demand-driven targets. Based on assessment of skill demand and 'Skill Gap Studies', target for skill training would be allocated to sector skill councils by NSDC in consultation with the SSCs, States/Union Territories and the Central Ministries/Departments under the oversight of the Steering Committee of PMKVY.

Target aligned to national flagship programmes and regions. Target for skill training would be aligned to the demand from the Central government's flagship programmes such as 'Swachh Bharat', 'Make in India', 'Digital India', 'National Solar Mission', and so on.

Training Content. While the thrust would be on outcomes in terms of third party assessment/certification, training providers (government affiliated training centres and other training centres) will focus on improved curricula, better technology enabled pedagogy and upgrading the capacity of instructors to enable the overall ecosystem for

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high quality skill training in the country. All skill training will include soft skill training, personal grooming, behavioural change for cleanliness, and good work ethics as a part of the training curricula.

Eligibility and Mobilisation

PMKVY is applicable to any candidate of Indian nationality who: (*i*) undergoes a skill development training in an eligible sector by an eligible training provider; (*ii*) is certified during the span of one year from the date of launch of the scheme by approved assessment agencies; and (*iii*) is availing this monetary award for the first and only time during the operation of this Scheme.

Efforts will be made through various government agencies to ensure greater outreach and ownership. A 'camp-based' approach by organising 'Kaushal-Melas' to disseminate information about various skill training options, outline possible career paths and income generation potential once the training is imparted, would be held in every district. Efforts will be made to ensure that the coverage of the scheme is across all the 543 constituencies in India.

APPENDIX III TO CHAPTER 12

DEEN DAYAL UPADHYAYA – GRAMEEN KAUSHALYA YOJANA

The Deen Dayal Upadhyaya – Grameen Kaushalya Yojana (DDU-GKY) is the flagship placement linked skill training programme under the Ministry of Rural Development. Announced on September 23, 2014, DDU-GKY is a critical component of the National Skill Development Policy, and has an ambitious agenda, to benchmark wage placement-linked skill programmes to global standards and requirements. The ultimate aim is to convert India's demographic surplus into a demographic dividend by developing rural India into a globally preferred source of skilled labour. As a result, the scheme will also benefit more than 55 million poor rural youth who are ready-to-be-skilled, by providing sustainable employment. In this way, the scheme is expected to play a crucial role in reducing poverty levels. Thus, ***the mission of DDU-GKY is to reduce poverty by enabling poor households to access gainful and sustainable employment through employment that provides a regular wage.*** DDU-GKY is also designed to be a major contributor to the Prime Minister's Make in India Campaign.

Guiding Principles

(*i*) There is a strong demand for economic opportunities among the poor, as well as immense opportunities in terms of developing their work abilities.

(*ii*) Social mobilization, as well as a network of strong institutions are essential in order to develop India's demographic surplus into a dividend.

(*iii*) Quality and standards are paramount in the delivery of skilling, in order to make the rural poor desirable to both Indian and global employers.

Key Features

The DDU-GKY is a market-led, placement-linked training programme for the rural youth, undertaken through the PPP route by Project Implementing Agencies (PIA). PIAs are mandated to assure placement to 75 per cent of candidates trained by them. ***The focus of these programmes is on the rural youth from poor families, in the age group of 15 to 35 years,*** belonging to: (*i*) MGNREGA worker household in which household members have together completed 15 days of work, (*ii*) RSBY (Rashtriya Swasthya Bima Yojana) household; (*iii*) Antyodaya Anna Yojana card holder; (*iv*) BPL PDS card households; (*v*) NRLM-SHG household; and (*vi*) Household covered under auto inclusion parameters of SECC 2011.

Full social inclusion of candidates is ensured by the mandatory coverage of socially disadvantaged groups – 50 per cent allocation to SC/ST groups, 15 per cent to minorities and 33 per cent for women.

Regional inclusion of candidates is enabled through a special sub-scheme for the youth of Jammu and Kashmir, called Himayat; and a special initiative for the rural youth of poor families in 25 most-affected Left-Wing Extremist (LWE) districts across nine States, called Roshni.

The scheme mandates a minimum salary of ₹ 6,000 per month for workers who have received placement after a three month training course; post-placement support to candidates; and career progression support to training partners. In allocation of skill projects, primacy is given to Training Partners who can train and support overseas placement and captive placements.

The programme promotes the Prime Minister's 'Make in India' Campaign through Industry Internships, supported by joint partnerships between industry and DDU-GKY.

DDU-GKY is applicable to the entire country. By training holistic, job-ready candidates to simultaneously meet our objectives of economic growth and poverty alleviation, the DDU-GKY strategy aims at helping industries prosper and grow, not just nationally but on a global level.

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14 Chapter

NATIONAL INCOME OF INDIA: MACROECONOMIC OVERVIEW

How well an economy performs is a matter of great concern to all those who are directly associated with it. But how to judge its performance? This is a question we have attempted to answer in Chapter 1. Here, it would suffice to say that national income trends, particularly the changes in gross or net national product, per capita gross or net national product and sectoral distribution of gross or net domestic product adequately reflect the progress of the economy. In this chapter, we shall confine our analysis only to such national income measures which indicate the growth trends and structural changes. Hence, our analysis will address the following issues:

- India's national income (NNP) trends since the beginning of economic planning
- Per capita national income as it has grown over the planning period
- Services led growth
- National product by industry of origin.

THE NATIONAL INCOME (NNP) TRENDS

The CSO (Central Statistical Organisation) has recently shifted the base year from 2004-05 to 2011-12. However, the new series presents data for only the period commencing 2011-12. Therefore, it cannot be used for the study of NNP trends for the entire planning period. According to the old series (base year 2004-05), India's net national income (at constant prices) was ₹ 2,69,724 crore in 1950-51 and this rose to ₹ 13,42,031 crore in 1990-91 and further to ₹ 49,58,849 crore in 2011-12. According to the new series (base year 2011-12), India's net national income (at constant prices) was ₹ 77,42,330 crore in 2011-12 and this rose to ₹ 1,23,29,646 crore in 2018-19. The rate of growth of national income was as high as 8.1 per cent in 2016-17, 7.0 per cent in 2017-18 and 6.9 per cent in 2018-19. per cent in 2017-18. ***In some years of the recent past, India has been the fastest growing major economy of the world – ahead even of China.***

Plan-wise Growth of National Income — Modest Growth Rate Period (1951-1980)

The target of growth in national income in the First Plan was very modest. As compared to the target, performance of the economy during the First Plan period might look extremely good (the national income had risen at a compound rate of 4.6 per cent per annum as against the target of 2.1 per cent per annum). An encouraging feature of growth during the First Plan period was that the increase in the national income was progressive and steady.

Bolder targets were fixed in the Second Plan in respect of national income. It was contemplated that national income would increase at the rate of 4.5 per cent per annum at constant prices. This, however, could not be realised and the rate of increase in national income was only 4.1 per cent per annum leaving a gap of 0.4 per cent per annum between the target and actual performance. Moreover, rise in national income was not achieved at a steady rate. But for the favourable weather conditions in 1958-59 and 1960-61 the performance of the economy during the Second Plan period would have been extremely distressing.

The Third Plan was comparatively a bigger plan from the point of view of investments and targets. It had contemplated a 5.6 per cent annum increase in the national income. However, the real rate of growth turned out to be only 3.3 per cent per annum. The performance in the Fourth Plan was equally distressing. As against the target of 5.7 per cent per annum increase in net domestic product, the annual rate of increase of national income was only 3.0 per cent.

The Fifth Plan had contemplated an increase in the gross domestic product of the order of 4.4 per cent per annum. The national income, however, recorded a growth rate of 5.0 per cent per annum which was certainly impressive considering the past record. During the Fifth Plan period though national income target was surpassed, yet the growth rate was as erratic as it had been in the past. In fact, the national income had risen substantially only in the years of exceptionally good harvests. The intervening year of 1979-80 between the Fifth and the Sixth Plans registered a negative growth of 5.9 per cent in the national income. Hence, in six-year period

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Box 14.1

Growth Performance in the Five Year Plans

(per cent per annum)

Five Year Plan		Target	Actual
1. First Plan	(1951-56)	2.1	4.6
2. Second Plan	(1956-61)	4.5	4.1
3. Third Plan	(1961-66)	5.6	3.3
4. Fourth Plan	(1969-74)	5.7	3.0
5. Fifth Plan	(1974-79)	4.4	5.0
6. Sixth Plan	(1980-85)	5.2	5.3
7. Seventh Plan	(1985-1990)	5.0	5.8
8. Eighth Plan	(1992-1997)	5.6	6.5
9. Ninth Plan	(1997-2002)	6.5	5.4
10. Tenth Plan	(2002-2007)	8.0	7.6
11. Eleventh Plan	(2007-12)	9.0	7.5
12. Twelfth Plan	(2012-17)	8.0	6.7

Note: The growth target for the first three plans was set with respect to National Income. In the Fourth Plan, it was Net Domestic Product. In all plans thereafter it has been Gross Domestic Product at factor cost. Actual growth rate under all the plans is estimated in terms of national income (NNP at factor cost at 2004-05 prices for the first Eleven Plans and NNP at factor cost at 2011-12 prices for the Twelfth Plan).

Sources: (*i*) Government of India, Planning Commission, *Eleventh Five Year Plan,* 2007-12, (New Delhi, 2008), Vol. I. Table 2.1, p. 25; and (*ii*) Government of India, *Economic Survey*, 2017-18 (New Delhi, 2018), Statistical Appendix, Table 1.2, pp. A3-A5.

from 1974-75 to 1979-80, annual rate of growth was just 3.6 per cent.

Growth Rate during the 1980s

The Sixth Plan had set a target of around 5.2 per cent per annum increase in gross domestic product. As against this target, national income rose by 5.3 per cent per annum. However, even this growth was mainly the result of good agricultural performance and a rapid growth in the services sector. The rate of growth of income generated in manufacturing and mining sector was well below the target and was unstable from year-to-year.

During the Seventh Plan period, gross domestic product was projected to increase at the rate of 5 per cent per annum. However, the economy performed extremely well and the national income rose at an annual rate of 5.8 per cent. During the Seventh Plan period, almost all major sectors registered satisfactory growth rates. The average performance of the agricultural sector showed some improvement in this period as compared to the 1970s and the first half of the 1980s. The manufacturing sector also performed reasonably well and the production in this sector rose at an annual rate of 6.7 per cent. Financing, transport and communication, trade, hotels and restaurants, and community and personal services were some other sectors in which annual growth rate of income exceeded 6.5 per cent.

There was acceleration of national income growth in the decade of 1980s. The economy had registered a low rate of growth during the late 1960s and 1970s. Therefore some economists characterise the decade of 1980s as the decade of economic buoyancy and recovery. This economic buoyancy cannot be attributed to any new source of stimulus to growth in the country's economy. C.P. Chandrasekhar and Jayati Ghosh have aptly remarked, ***"Exports during these years were by no means remarkable enough to stimulate growth in an economy as large as that of India. And the factors which had earlier constrained the expansion of the mass market were still operating. This implied that the stimulus to growth, as before, had to come from the State."***[1]

And this actually happened during the 1980s. ***Three factors allowed the economy to register higher growth in the 1980s as compared to the 1960s and 1970s. First, the increased government expenditure provided fiscal stimulus to the economy. Second, liberalisation of imports, especially of capital goods and components of manufacturing induced production of luxury articles*** such as automobiles and electronic goods. Since import liberalisation of the 1980s was not accompanied by a larger export effort, it led to dramatic increase in balance of payments deficit. ***Third, associated with these two factors, there was an increased reliance on external commercial borrowing by the State***

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in order to finance increased fiscal and current account deficits.

In the first two years following the Seventh Plan period, the rate of increase in national income of the 1980s could not be sustained and the country passed through a phase of major economic crisis. Given their understanding of the 1990s crisis, domestic liberalisers backed by the IMF persuaded the government to adopt the neo-liberal reform programme of the Washington consensus.[2] With the implementation of these macro-stabilisation and structural adjustment policies, it was hoped that the reforms would put the Indian economy on a high growth path.

Growth Rate during the Liberalisation Phase

During the five years of the Eighth Plan, that is, from 1992-93 to 1996-97, the national income rose at the rate of 6.5 per cent per annum as against the target of 5.6 per cent per annum. This was definitely an encouraging performance. However, one of the important reasons in this acceleration of growth was the inflows of foreign capital. Dependence of economic growth on inflows of foreign capital is a risky proposition as they can easily disappear in the face of economic or political uncertainty.[3] Therefore, excessive reliance on capital inflows in an environment of lax macroeconomic policies is a risky proposition. This was dramatically illustrated by the crisis that hit Mexico in December 1994 and East Asian countries in 1997-98. The average annual rate of increase in national income during the Ninth Plan (1997-2002) was only 5.4 per cent which was significantly lower than the growth rate achieved during the Eighth Plan and the targeted rate of growth in this plan. ***The lacklustre performance of the economy during the Ninth Plan period was due to the failure of the two most important sectors of the economy — agriculture and manufacturing.*** Agriculture registered a rate of growth of only 2.5 per cent per annum and manufacturing a rate of growth of only 3.3 per cent per annum during the Ninth Plan period.

The period of Tenth Plan (2002-03 to 2006-07) registered a significant growth in national income of 7.6 per cent per annum. The growth in GDP at factor cost in this plan was 7.8 per cent per annum as against the target of 8.0 per cent per annum. In fact, ***over the four years ending 2006-07, India's domestic output grew annually at 8.6 per cent, making it the world's second fastest growing economy after China.*** This includes an 8.8 per cent annual growth rate of manufacturing during the five years between 2002-03 and 2006-07, and a sustained growth in services at 9 per cent annually during the six years since 2001-02.[4] This emboldened the government to fix 9 per cent per annum economic growth target for the Eleventh Five Year Plan (2007-12). The actual rate of growth of GDP in this Plan was 8.0 per cent per annum (the rate of growth of NNP stood at 7.5 per cent per annum). The Twelfth Five Year Plan (2012-17) had the GDP growth rate target of 8.0 per cent per annum. The actual rate of growth of NNP in this Plan was 6.7 per cent per annum. Data from 2011-12 onwards are available from the new series with base year 2011-12. According to this series, GDP at constant (2011-12) prices rose by 8.2 per cent in 2016-17, 7.2 per cent is 2017-18 and 6.8 per cent in 2018-19. GVA at basic constant prices (2011-12) increased by 7.9 per cent in 2016-17. 6.9 per cent in 2017-18 and 6.6 per cent in 2018-19. India has emerged as the fastest growing major economy in the world in some of the recent years. According to *Economic Survey* 2015-16, ***the recent growth revival in India is predominantly consumption-driven.***[5]

Main Features of the NNP Growth

The above description of the national income trends during the past six decades clearly highlights the main features of growth in this country. We shall now summarise them as follows:

1. Erratic growth. The increase in national income during the period of economic planning has been erratic. On careful scrutiny of the growth rates in different years, we notice that out of 65 years of economic planning in as many as 9 years, either the net national product registered a decline or the rate of increase in it was lower than the rate of population growth. Consequently, the rate of growth of per capita income (at 2004-05 prices) showed a decline in these years. It is shocking that the absolute level of the net national product (at 2004-05 prices) declined in 5 years (1957-58, 1965-66, 1966-67, 1972-73 and 1979-80). The data on the national income clearly suggest that whatever growth we witness in this country has taken place only in about half of the years of economic planning; in rest of the years either there has been little growth or the country has actually suffered economic retrogression. These facts clearly suggest that ***the national income trends during the period of economic planning do not indicate a consistent increase.***

2. Growth rate fluctuates with fluctuations in agriculture. The national income level and the rate of growth in it fluctuate with fluctuations in the harvests. One might say that this is inevitable in agricultural countries as they generate about one-third of their national income in this sector. However, in India's case it is somewhat surprising that the planning and particularly the investment in agriculture under the various plans, have not made any significant impact on the uncertainty

* Data for GDP and GVA growth given here for the years 2016-17 and 2017-18 are based on CSO's Second Advance Estimates released on February 28, 2018.

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in agriculture. ***Weather conditions, especially the rains, even now put agriculture out of gear and this, in turn, affects the performance of other sectors as well.***

3. Acceleration in growth rate in recent period. The compound rate of increase in the national income in India during the first thirty years of economic planning was just 3.5 per cent per annum. It picked up to 5.9 per cent per annum over the period 1980-81 to 2011-12. The government very much publicised this performance. However, even this rate of growth was modest by any standards. Moreover, according to some economists like R. Nagaraj, this better rate of growth was partly due to overestimation of growth in certain sectors of the economy. Some economists also pointed out that rapid income growth remained confined in a few regions which implies that most of the States continued to record extremely low growth rates.

However, in the above context, it needs to be pointed out that growth rates of national income (NNP at factor cost) have improved over recent decades – from 4.7 per cent per annum in 1980s (1980-81 to 1989-90) to 5.3 per cent per annum in 1990s (1990-91 to 1999-2000) and further to 6.8 per cent per annum over the twelve year period 2000-01 to 2011-12. In fact, Indian economy has performed considerably well in the last 3-4 years with GDP at constant (2011-12) prices increasing at a rate of 8.2 per cent in 2016-17, 7.2 per cent in 2017-18 and 6.8 per cent in 2018-19. As stated earlier, India has emerged as the fastest growing major economy in the world in some of the recent years.

4. Post-1991 reform growth less fragile. Three major studies on growth rate of the Indian economy focussing mostly on the post-reform decade of 1990s and published in the early months of 2004 explored the supposed change of trajectory in the long-term growth rate of the Indian economy in the context of 'post-reform' period. Arvind Virmani in his study "India's Economic Growth",[6] Arvind Panagariya in his IMF Working Paper "India in the 1980s and 1990s: A Triumph of Reforms"[7] and Rodrik Dani and Arvind Subramanian in the their NBER working paper "From Hindu Growth to Productivity Surge: The Mystery of the Indian Growth Transition,"[8] argued that the rate of growth during the 1990s was higher than the rate of growth during the 1980s. They all noted that the growth rate had accelerated during the 1980s. ***Going strictly by the numbers, growth rate average during the post-reform decade of 1990s over the pre-reform decade of 1980s was found to be higher, though none of these studies claimed that there was a significant improvement during the 1990s.***

The three studies attributed acceleration of economic growth during the 1980s to different factors. According to Panagariya's study, liberalisation played a significant role even during the 1980s. Rodrik and Subramanian assert that reforms in the 1980s were not pro-liberalisation but pro-business. Thus, they served to boost profits of existing business. According to Virmani, incremental rather than revolutionary individual reforms were introduced by the government during the 1980s. Thus, there was acceleration in the growth rate. At the same time, growth was fragile and the economy was led to economic crisis in 1990-91. ***Both Panagariya and Virmani's studies conclude that post-1991 reform growth is less fragile.*** Panagariya's study indicates that "the variance of growth rates during the 1980s is statistically significantly higher than that in the 1990s." Virmani also found that the coefficient of variation in GDP growth rate fell to 20 per cent during the 1990s from 50 per cent during the 1980s.

PER CAPITA NATIONAL INCOME

From the time India switched over to economic planning, the net national product has continued to grow, despite erratic growth in agricultural production and shortfalls in the industrial output. There is no doubt that this is an encouraging development in an economy which had suffered long spells of stagnation under the British. However, assessment of the performance of an economy can more accurately be made by examining the trends in per capita national income which is the same thing as per capita net national product at factor cost.

Trends in Per Capita National Income

India's per capita net national income at constant prices was ₹ 7,513 in 1950-51 and this rose to ₹ 41,255 in 2011-12 (2004-05 series). According to the new series with base year 2011-12, India's per capita income was ₹ 63,462 in 2011-12 and this rose to ₹ 92,565 in 2018-19. As far as the rate of growth of per capita income is concerned, it was 2.7 per cent per annum during the First Plan and 2.1 per cent per annum during the Second Plan. However, it was merely 1.0 per cent per annum in the Third Plan and almost negligible in the Fourth Plan. It picked up somewhat in later plans but remained unsteady and erratic. There were years of spurts in per capita net national income, but there were also some years in which it either declined or remained constant. Further, years of spurts in per capita net national income were the same in which agricultural production had increased significantly, and the periods in which per capita net national income had either declined or fluctuated around the level achieved in the preceding year were not different from those marked by bad weather resulting in crop failures. Such a pattern of economic growth brings credit neither to the society, nor to the planning system followed by the government in this country. However, the post-reform period (the period since

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1991) has witnessed fairly high rates of growth. In particular, per capita net national income rose by as high as 5.9 per cent per annum in the Tenth Plan and 6.0 per cent per annum in the Eleventh Plan. The rate of growth of per capita net national income in the Twelfth Plan was 5.3 per cent per annum.

An International Comparison

An international comparison of growth rate is an extremely difficult and hazardous exercise. It has to be undertaken with full knowledge of the concepts and methods used in the estimation of different aggregates in every nation. For attempting an international comparison, the common practice is to convert the national income statistics of the different countries expressed in their national currencies into some common currency at the prevailing exchange rate. But in recent years this method has been subjected to some criticism. This, however, does not mean that international comparison is wholly futile and need not be attempted. Keeping these limitations in mind, it is possible to hazard international comparison only to draw some broad conclusions. The level of per capita net national product (or gross national product) gives a general indication of the historical achievement of an economy up to a particular year while the rate of increase in per capita net national product (or gross national product) indicates the speed at which the economy has grown over a certain period.

Table 1.1 in Chapter 1 shows the gross national product (GNP) per capita and PPP estimates of GNP per capita of some selected developed and underdeveloped countries in 2016.

Taking cognizance of the non-comparability of figures of per capita incomes of different countries, it is not desirable to read too much into them. ***It can***, however, ***be safely concluded that the PPP per capita income of developed economies is more than 10 times the PPP per capita income of India***. Even among the underdeveloped countries, India's position is not enviable. These facts clearly suggest that India in future cannot afford to remain complacent in its growth efforts. ***Even to acquire a comparatively respectable position among the underdeveloped countries, it has no choice but to speed up its pace of growth.***

The developed economies in the recent past have registered only modest rates of growth. Among the developed countries not even Japan has recorded a higher rate of increase in per capita income than that in India. Yet because of the extraordinarily high levels of per capita income in developed countries, the gap between these countries and India's level of development is widening with the passage of time and this country has to grow faster even to maintain its relative position.

SERVICES LED GROWTH

In 1950-51 agriculture and allied activities was the dominant sector and it accounted for 53.1 per cent of the GDP. The share of industry (includes mining and quarrying, manufacturing, construction, and electricity, gas and water supply) was only 16.6 per cent while the share of services (also known as the tertiary sector) was around 30 per cent. With the start of the planning process, the importance of industry and services increased while that of agriculture declined. By 1980-81, the services sector with a share of 38.0 per cent had overtaken the agricultural sector (whose share was 36.1 per cent). In this year, the share of industry in GDP was 25.9 per cent. After this, there was a clear and significant compositional shift in favour of services. ***In 2013-14, the share of services in GDP was as high as 59.9 per cent while the share of agriculture and allied activities slipped to only 13.9 per cent (the share of industry being 26.2 per cent). According to the new series with base year 2011-12, the share of services in GVA was 53.2 per cent in 2016-17 and 54 per cent in 2017-18.*** In fact, the economic growth in the last few years has been propelled by services. Even in Ninth Plan when there was a slowdown in overall economic growth, services continued to grow fast. This is clear from the fact that whereas agriculture in this Plan grew by only 2.5 per cent per annum and industry by 4.3 per cent per annum, services grew at a rate of 7.9 per cent per annum.[9] Moreover, ***expansion of services accelerated further in the years after 2002-03, propelled by high rates of growth in communications (especially telecom), business services (especially information technology) and finance.***[10] The exceptionally rapid growth in India's services sector and its contribution to overall economic growth since 1991 would be clear from Table 14.1.

As is clear from Table 14.1, in the five years between 1991-92 and 1996-97, services contributed just about half of total growth in GDP. In the subsequent five years 1996-97 to 2001-02, the contribution of services to growth increased significantly to 68.3 per cent, and remained at a high 60.4 per cent over the next six years following 2001-02. During 2008-09 to 2013-14, the contribution of services to GDP growth was as high as 69.8 per cent. According to the new series with base year 2011-12, the contribution of services to GVA growth over the seven year period 2011-12 to 2017-18 was as high as 64.5 per cent (i.e., a little less than two-thirds). As noted by Acharya, "these shares would be even higher if the construction sub-sector were included under services instead of industry".[11]

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Table 14.1
Sectoral Composition of Growth

	Share in GDP (%)			*Share in GVA (%)*		*Contribution to GDP growth*				*Contribution to GVA growth*
	1950-51	*1980-81*	*2013-14*	*2016-17*	*2017-18*	*1991-97*	*1996-2002*	*2001-2008*	*2008-14*	*2011-12 to 2017-18*
	(Base year 2004-05)			*(Base year 2011-12)*		*(Base year 2004-05)*				*(Base year 2011-12)*
Agriculture	53.1	36.1	13.9	15.3	14.8	21.1	11.5	7.1	9.1	7.0
Industry	16.6	25.9	26.2	31.5	31.2	29.0	20.2	32.5	21.1	28.5
Services	30.3	38.0	59.9	53.2	54.0	49.8	68.3	60.4	69.8	64.5
GDP/GVA	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: (*i*) Shankar Acharya, "Macroeconomic Performance and Policies, 2000-08" in Shankar Acharya and Rakesh Mohan (ed.), *India's Economy: Performance and Challenges* (New Delhi, 2010), Table 4.2, p. 120; (*ii*) *Economic and Political Weekly*, February 23, 2014, p. 89; and (*iii*) Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Table 3.

The above analysis clearly brings out the 'services-led' pattern of economic growth in India. Some development economists have argued that the rapid growth of the services sector in India in recent years reflects the ***structural transformation*** of the economy as it moves to a somewhat higher level of development. However, a question has been raised regarding the ***sustainability*** of this pattern of growth. Some economists have argued that the present pattern of growth is not sustainable as the services sector alone does not have the capacity to sustain overall growth for long. However, in a recently published article, Sunil Jain and T.N. Ninan have argued that with the passage of time, the network of existing services is likely to expand further substantially and many new services are likely to be added. As a result, the service sector growth will be sustainable.[12] However, agriculture's poor growth is a cause of worry. As is clear from Table 14.2, agriculture's contribution to GDP growth after 1996-97 is low and declining even though almost half of the country's labour force is employed in this sector. Remedial measures are urgently required to push up growth in the agricultural sector.

NATIONAL PRODUCT BY INDUSTRY OF ORIGIN

The study of national income by industry of origin is important to explain the anatomy of the economic structure. Table 14.2 presents detailed information in this regard.

Agriculture and Allied Activities (Primary Sector)

During the post-Independence period, the share of agriculture and allied activities (or the primary sector) in gross domestic product (GDP) has declined consistently – from 53.1 per cent in 1950-51 to 36.1 per cent in 1980-81, 22.3 per cent in 2000-01 and only 13.9 per cent in 2013-14 (according to series with base year 2004-05). According to new series (base year 2011-12), the share of agriculture and allied activities in GVA at basic prices was 15.2 per cent in 2016-17 and 14.8 per cent in 2017-18.

The above data show that the importance of the primary sector in national income has declined considerably in recent years. Transport and trade, banking and insurance and other service sectors have grown faster than agriculture and this fact is reflected in the estimates of gross domestic product by industry of origin. These changes notwithstanding, the agricultural sector still remains an important sector in the Indian economy. Even now for a larger increase in the country's national income, rapid growth of the agricultural sector is necessary. The linear rate of increase in income in the agricultural sector during the planning period which comes to about 2.8 per cent does not compare very unfavourably with rates recorded in other countries placed broadly in comparable situations.

Industry (Secondary Sector)

Industry comprises mining and quarrying, manufacturing, construction, and electricity, gas and water supply. The share of this sector in GDP at factor cost (at 2004-05 prices) was 16.6 per cent in 1950-51 and this rose more or less consistently to 27.7 per cent in 1990-91. It stood at 27.3 per cent in 2012-13 and fell to 26.2 per cent in 2013-14. According to new series with base year 2011-12, the share of industry in GVA at basic prices was 31.5 per cent in 2016-17 and 31.2 per cent in 2017-18.

Mining and quarrying. The contribution of mining and quarrying to GDP was 1.9 per cent in 1950-51. It rose to 3.5 per cent of GDP in 1990-91 but fell thereafter. It was again 1.9 per cent of GDP in 2013-14 (base year 2004-05). According to new series with base year 2011-12, the share of mining and quarrying in GVA at basic prices was 3.3 per cent in 2016-17 and 3.2 per cent in 2017-18.

Manufacturing. Manufacturing is the predominant activity in the secondary sector. Its share in GDP was 9.2 per cent in 1950-51. This rose to 12.9 per cent in 1970-71

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and 15.1 per cent in 1990-91. The share of manufacturing in GDP at factor cost was 15.8 per cent in 2012-13 and this fell to 14.9 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of manufacturing in GVA at basic prices was only 18.1 per cent in 2016-17 and 18.1 per cent in 2017-18. The failure to increase the share of manufacturing in GDP significantly is a cause of concern both for robust economic growth and for creating ample employment opportunities.

Electricity, gas and water supply. This sector in India is relatively small. In a rapidly growing economy, its rate of growth is usually high. In India since the trend rate of growth of GDP over the period 1950-51 to 2013-14 has been as low as 4.9 per cent per annum, the electricity, gas and water supply sector has expanded rather slowly. This sector accounted for 1.9 per cent of the country's GDP in 2013-14 (at 2004-05 prices). The share of electricity, gas and water supply in GVA at basic prices was 2.2 per cent in 2016-17 and 2017-18.

Construction. In a growing economy, construction work is undertaken on an expanded scale. It is this reason why the absolute size of this sector has grown over the years. However, its share in India's gross domestic product did not increase substantially for a considerable period of time. During the last few years, with the expansion of the infrastructure sector, construction activity has increased significantly. As a result, the contribution of construction to GDP rose to 7.4 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of construction in GVA at basic prices was 7.8 per cent in 2016-17 and 2017-18.

Services (Tertiary Sector)

As is clear from Table 14.2, the services sector has grown rapidly during the period of planning. Its share in GDP was 30.3 per cent in 1950-51 and this has increased to about 60 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of services in GVA at basic prices was 53.2 per cent in 2016-17 and 54.0 per cent in 2017-18.

Trade, hotels, transport and communications. The share of this sector in GDP has increased considerably over the period of planning – from 11.3 per cent in 1950-51 to 26.4 per cent in 2013-14 (*i.e.,* from a little more than one-tenth to more than one-fourth). As can be seen from Table 14.2, the period of economic reforms (the post-1991 period) has seen a fast growth in this sector with its share in GDP rising from 17.7 per cent in 1990-91 to 26.4 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of trade, hotels, transport and communications in GVA at basic prices was 19.0 per cent in 2016-17 and 19.3 per cent in 2017-18 (i.e., almost fifth).

Financing, insurance, real estate and business services. Growth of banking, non-bank financial intermediaries, development banking and insurance is inevitable in a developing economy. Since 1969 when major commercial banks were nationalised, banking has registered spectacular growth. In order to mobilise growing savings in the household sector for investment purposes, institutions like UTI and LIC also expanded their activities. During the period of the last two decades, there has been a rapid growth of business services (especially information technology), real estate activity has also picked up considerably in recent years due to easy availability of housing loans and inflationary conditions in the economy (which make investment in real estate highly lucrative). Because of all these factors, the share of financing, insurance, real estate and business services in GDP at factor cost increased considerably over the years – from 8.5 per cent in 1950-51 to 11.5 per cent in 1990-91, 14.1 per cent in 2000-01 and further to 20.6 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of financing, insurance, real estate and business services in GVA at basic prices was 21.7 per cent in 2016-17 and 2017-18.

Community, social and personal services. This group includes public administration, defence and other services. Over the years, there has been substantial expansion in the size of the government sector with the result that the share of public administration in GDP increased. There has been an increase in expenditure on defence as well. Because of these factors, the share of community, social and personal services in GDP rose during the first four decades of economic planning – from 10.4 per cent in 1950-51 to 14.7 per cent in 1990-91. During the period of economic reforms, the share of community, social and personal services in GDP has somewhat declined and stood at 12.9 per cent in 2013-14 (at 2004-05 prices). According to new series with base year 2011-12, the share of public administration, defence and other services in GVA at basis prices was 12.5 per cent in 2016-17 and 13.0 per cent in 2017-18.

Conclusion

A study of GDP by industry of origin clearly brings out the declining importance of agriculture in Indian economy and the rapid growth of the services sector. However, the continued dependence of about half of the labour force on agriculture for its livelihood should be sufficient to bring out the important role that agriculture continues to play. Moreover, any setbacks in agricultural production have serious repercussions on the whole of the economy. While

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Table 14.2

Estimates of GDP/GVA by Industry of Origin – Percentage Distribution

Industry Share in GDP	*Share in GVA*						
	2004-05 prices					*2011-12 prices*	
	1950-51	*1980-81*	*2000-01*	*2012-13*	*2013-14*	*2016-17*	*2017-18*
I. Agriculture and allied activities	**53.1**	**36.1**	**22.3**	**13.9**	**13.9**	**15.3**	**14.8**
1. Agriculture	42.8	30.1	18.8	11.8	N.A.	N.A.	N.A.
2. Allied activities	10.3	5.9	3.5	2.1	N.A.	N.A.	N.A.
II. Secondary Industry	**16.6**	**25.9**	**27.3**	**27.3**	**26.2**	**31.5**	**31.2**
3. Mining and quarrying	1.9	2.6	3.0	2.0	1.9	3.3	3.2
4. Manufacturing	9.2	14.1	15.5	15.8	14.9	18.2	18.1
5. Electricity, gas and water supply	0.3	1.5	2.2	1.9	1.9	2.2	2.2
6. Construction	5.2	7.7	6.6	7.6	7.4	7.8	7.8
III. Services	**30.3**	**38.0**	**50.4**	**58.8**	**59.9**	**53.2**	**54.0**
7. Trade, hotels, transport and communications	11.3	16.9	21.6	26.9	26.4	19.0	19.3
8. Financing, insurance, real estate and business services	8.5	8.2	14.1	19.1	20.6	21.7*	21.7*
9. Community, social and personal services	10.4	12.9	14.7	12.8	12.9	12.5**	13.0**
GDP at factor cost	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

* Data pertain to 'financial, real estate and professional services'.

** Data pertain to 'public administration, defence and other services'.

Note: 1. N.A.: Not available.

2. Sums of industrial items may not add up to totals because of rounding up.

Source: Computed from Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2011-12 (Mumbai, 2012) and *Handbook of Statistics on Indian Economy* 2016-17 (Mumbai, 2017), Table 2, pp. 8-10 and Table 3, pp. 11-13.

industrial sector is indeed expanding, yet its growth is totally insufficient to absorb the increasing number of job seekers that keep entering the labour force year after year. Given the technology-intensive nature of many sub-sectors of the services sector, it is essential to pull up the growth of the industrial sector (particularly the manufacturing sector) if the problem of unemployment has to be tackled.

NOTES

1. C.P. Chandrasekhar and Jayati Ghosh, *The Market That Failed – A Decade of Neo-liberal Economic Reforms in India* (New Delhi, 2002), p. 9.
2. Washington consensus was reached at between IMF and World Bank in the early 1990s. It is essentially neo-liberal and is based on the alleged superiority of the free market and free trade for the achievement of more rapid economic progress. It advocates fiscal discipline, privatisation and deregulation, trade liberalisation and tax reforms, etc.
3. Bimal Jalan, *India's Economic Policy* (New Delhi, 1996), p. 114.
4. R. Nagaraj, "India's Recent Economic Growth: A Closer Look", *Economic and Political Weekly*, April 12, 2008, p. 55.
5. Government of India, *Economic Survey* 2015-16 (Delhi, 2016), Volume II, p. 5.
6. Arvind Virmani, "*India's Economic Growth from Socialist Rate of Growth to Bhartiya Rate of Growth*", Indian Council for Research, February, 2004.
7. Arvind Panagariya, "India in the 1980s and 1990s: A Triumph of Reforms", *IMF Working Paper*, wp/04/43, March 2004.
8. Dani Rodrik, and Arvind Subramanian, "From Hindu Growth to Productivity Surge: The Mystery of the Indian Growth Transition", *NBER Working Paper*, No. 376 (March, 2004).
9. Shankar Acharya, "Macroeconomic Performance and Policies, 2000-08", in Shankar Acharya and Rakesh Mohan (ed.), *India's Economy: Performance and Challenges* (New Delhi, 2010), Table 4.1, p. 119.
10. *Ibid.*, p. 118.
11. *Ibid.*, p. 120.
12. Sunil Jain and T.N. Ninan, "Servicing India's GDP Growth", in Shankar Acharya and Rakesh Mohan (ed.), *India's Economy: Performance and Challenges* (New Delhi, 2010), p. 336.

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15 Chapter

POVERTY IN INDIA

In almost all underdeveloped countries where per capita income is very low, income inequality has resulted in a number of evils, of which poverty is certainly the most serious one. In India, even now in spite of all the development during the period of planning, a large number of people live below the poverty line. Most of the time, these people also suffer from extreme destitution.

In this chapter, we propose to discuss the following issues:

- The concept of poverty line
- Incidence of poverty in India
- Multidimensional poverty
- Safety nets for the poor: Poverty alleviation programmes
- Strategy of poverty alleviation
- The concept of Universal Basic Income (UBI).

THE CONCEPT OF POVERTY LINE

As pointed out by Tendulkar Committee, the concept of poverty is associated with socially perceived deprivation with respect to basic human needs. "These basic human needs are usually listed in the material dimension as the need to be adequately nourished, the need to be decently clothed, the need to be reasonably sheltered, the need to escape avoidable diseases, the need to be (at least) minimally educated and the need to be mobile for purposes of social interaction and participation in economic activity."[1] This shows that the concept of poverty is ***multidimensional.*** However, quantitative measurement of income to define poverty line on the basis of such a wide concept of poverty is not possible as this concept includes both material and non-material dimensions. Accordingly, while measuring poverty line, the focus generally has been on the material dimensions and even in this respect, only on minimum consumption requirements. In other words, absolute (private) consumption poverty line is taken to convey the inability of an individual or household to afford a socially perceived normative minimal basket of basic human needs that is expected to be reflected in some normative minimal standard of living that should be assured to every individual/household. The existing all-India rural and urban poverty lines, anchored in the per capita calorie norms of 2400 (rural) and 2,100 (urban) were originally defined in terms of per capita total consumer expenditure (PCTE) at 1973-74 market prices and adjusted over time across States for changes in prices. ***The all-India poverty line so defined in 1973-74 was ₹49.63 for rural areas and ₹56.64 for urban areas. The all-India poverty line for 2004-05 adjusted for prices was ₹356.30 for rural areas and ₹538.60 for urban areas. For the year 2011-12, the Planning Commission has defined the poverty line as ₹27.20 per capita per day in rural areas and ₹ 33.33 per capita per day in urban areas. This translates to ₹816 per capita per month in rural areas and ₹1,000 per capita per month in urban areas. Rangarajan Committee (2014) defined poverty line for 2011-12 at ₹47 per capita per day for urban areas and ₹32 per capita per day for rural areas.***

INCIDENCE OF POVERTY IN INDIA

Earlier Estimates — 1960s

The estimates of poverty in India provided by Minhas, Ahluwalia, Bardhan, and Dandekar and Rath are quite old and do not indicate exactly the same incidence of poverty. As would be clear from Table 15.1, the divergence between the results of these economists is quite large.

Table 15.1

Estimates of Poverty in Rural India: 1967-68
(Per cent of Rural Population)

Author of the Estimates	*Incidence of Poverty*
B.S. Minhas	37.1
M.S. Ahluwalia	56.5
P.K. Bardhan	54.0
V.M. Dandekar and N.K. Rath (1968-69)	40.0

Ahluwalia, Bardhan, and Dandekar and Rath had determined poverty line slightly lower than the one determined by Minhas, and yet incidence of poverty according to their estimates was greater than that indicated by Minhas's estimates. This should not surprise anyone, because despite the fact that these economists used the same data source for

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Table 15.2
Percentage of Population Below the Poverty Line

Areas	1973-74		1983-84		1993-94	
	Poverty line (₹)	Percentage of persons	Poverty line (₹)	Percentage of persons	Poverty line (₹)	Percentage of persons
Rural	49.63	56.4	89.50	45.7	205.84	37.3
Urban	56.64	49.0	115.65	40.8	281.35	32.4
Combined	–	54.9	–	44.5	–	36.0

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2009-10 (Mumbai, 2010), Table 162, pp. 288-293.

their studies, their methodology was not the same. To non-experts these results may look intriguing, but even they should have no difficulty in realising the fact that not only the absolute number of poor in this country during the 1960s was large, but their proportion to the total population of the country was also very high.

Estimates for 1973-74 to 1998

The Planning Commission's Estimates. The Planning Commission has provided estimates of the incidence of poverty since the early 1970s. As stated earlier, it determined the poverty line for rural population at ₹ 49.63 (at 1973-74 prices) per capita per month while for urban population, poverty line was fixed at ₹ 56.64 per capita per month. These poverty lines have been updated over time keeping price changes in view. Estimates for the years 1973-74, 1983-84 and 1993-94 are presented in Table 15.2 alongwith poverty lines in these years.

According to this Table, ***more than half of the population was below the poverty line in 1973-74.*** Over the two decade period 1973-74 to 1993-94, there was a perceptible decline in the incidence of poverty — from 54.9 per cent in 1973-74 to 35.6 per cent in 1993-94. However, in view of the fact that the population had increased considerably over the period, it can be safely concluded that the absolute number of poor people did not decline. Moreover, many economists have pointed out serious flaws in the Planning Commission's methodology and have thus raised doubts about the claims of the Planning Commission regarding reduction in poverty.

Poverty Estimates Based on 55th Round of the NSSO

The 55th Round of the National Sample Survey (July 1999-June 2000) was a quinquennial large sample survey and was thus expected to generate data useful to prepare poverty estimates comparable with those from the previous large sample surveys. The possibility of this has however been questioned due to a fundamental change in the methodology adopted by the NSSO in this Round. The Planning Commission nevertheless made use of these data to prepare two separate estimates of the incidence of poverty. These are provided in Table 15.3.

The consumer expenditure data of the 55th Round on a 30-day recall basis yields the poverty ratios for 1999-2000 of 27.09 per cent in rural areas, 23.62 per cent in urban areas and 26.1 per cent for the country as a whole. The corresponding figures from the 7-day recall period are 24.02 per cent in rural areas, 21.59 per cent in urban areas and 23.33 per cent for the country as a whole. Poverty line was defined as ₹ 327.56 per capita per month for rural areas and ₹ 454.11 per capita per month for urban areas.

Poverty Estimates Based on 61st Round of the NSSO

The 61st Round of the NSSO provides estimates on poverty for the year 2004-05 on the basis of two methods: (1) URP (Uniform Recall Period), and (2) MRP (Mixed Recall Period). While the consumption data for URP uses 30-day recall/reference period for all items of consumption, the consumption data for MRP uses 365-day recall/reference period for 5 infrequently purchased non-food items, namely,

Table 15.3
Poverty Estimates Based on the 55th NSS Round
(Year – 1999-2000)

(Per cent)

Reference Period	All-India	Rural	Urban
30 day recall	26.10	27.09	23.62
7 day recall	23.33	24.02	21.59

Source: Government of India, *Economic Survey 2000-2001*, Table 10.5, p. 194.

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clothing, footwear, durable goods, education and institutional medical expenses and 30-day recall/reference period for remaining items. Data on the basis of both the methods are presented in Table 15.4.

According to the 61st Round of NSSO, the poverty ratios for the country as a whole in 2004-05 were 27.5 per cent on the basis of URP and 21.8 per cent on the basis of MRP. Poverty ratio for rural India is considerably higher than the poverty ratio for urban areas on the basis of URP while it is almost the same on the basis of MRP.

Poverty Estimates of Tendulkar Committee

In view of the confusion generated by various claims and counter-claims regarding the incidence of poverty in India and on whether poverty has been declining or not, the Planning Commission constituted an Expert Group under the chairmanship of Suresh Tendulkar to examine the issue in entirety and suggest a new poverty line and estimates. Tendulkar Committee submitted its report in December 2009. The Committee pointed out three major criticisms of the existing official poverty lines: ***One,*** the consumption patterns underlying the rural and urban poverty line baskets (PLBs) remained tied down to those observed more than three decades ago in 1973-74 and hence had become outdated. Thus, they have failed to take into account the changes in the consumption pattern of the poor over time. ***Two,*** crude price adjustment for prices was leading to implausible results such as proportion of total urban population below poverty line being higher than its rural counterpart in certain major States. ***Three,*** the earlier poverty lines assumed that the basic social services of health and education would be supplied by the State and hence, although private expenditure in education and health was covered in the base year 1973-74, no account was taken of either the increase in the proportion of these in total expenditure over time or of their proper representation in available indices.[2]

Tendulkar Committee suggested a new methodology for estimating poverty lines. The main recommendations of the Committee were as follows:[3]

1. Need to move away from anchoring the poverty line to a calorie based norm. Thus, the quantum of various goods and services deemed to constitute the desirable national minimum standard of living would not be determined normatively but on the basis of observed patterns of consumption reported by a reference group of 'poor' urban households.

2. Poverty estimates to continue to be based on private household consumer expenditure of Indian households collected by the NSSO (National Sample Survey Organisation).

3. Recognising the sensitivity of household responses on consumption expenditure to the reference period for which information is sought, the Committee suggested using estimates based on different reference periods for different commodity groups, rather than the earlier practice of a uniform 30-day reference period for all. Thus, instead of using URP (uniform recall period), the Committee opted for the use of MRP (mixed recall period) practice. This change is expected to capture the household consumption expenditure of poor households on low-frequency items of purchase more satisfactorily.

4. Broadening of the scope of the minimum standard of living by giving greater attention to its non-food components. In fact, the proposed poverty line basket (PLB) takes into account all items of consumption (except transport and conveyance) for construction of price indices. Separate allowance for private expenditure on transport and conveyance has been made in the recommended poverty lines.

5. Including private expenditure on education and health in determination of poverty line. The earlier practice was to omit this expenditure as providing basic health care and education for all children was deemed to be the responsibility of the State.

6. The new poverty lines seek to enable the rural as well as urban population in all States to afford the recommended all-India urban PLB after taking due account of within State rural-urban and inter-State differentials (rural and urban) incorporating observed consumer behaviour both at the all-India and State levels.

The Tendulkar Committee estimated the new all-India poverty line for the year 2004-05 for rural areas at ₹ 446.68 per capita per month and for urban areas at ₹ 578.80 per

Table 15.4

Poverty Estimates Based on the 61st NSS Round (Year – 2004-2005)

(Per cent)

Reference Period	*All-India*	*Rural*	*Urban*
Uniform Recall Period (URP) method	27.5	28.3	25.7
Mixed Recall Period (MRP) method	21.8	21.8	21.7

Source: Government of India, *Economic Survey*, 2007-08 (Delhi, 2008), Table 10.4, p. 243.

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capita per month. On this basis, ***41.8 per cent of the rural population and 25.7 per cent of the urban population was below the poverty line in 2004-05. For the country as a whole, 37.2 per cent of the people were below the poverty line in 2004-05.***

A comparison with Table 15.4 shows that the number of rural people below the poverty line according to Tendulkar Committee is much more than the number estimated in the 61st round of NSSO. The 61st round had estimated the number of people below the poverty line in rural areas at 28.3 per cent in 2004-05 following the URP method and merely 21.8 per cent following the MRP method. As against this, Tendulkar Committee estimates the number of rural people below the poverty line at 41.8 per cent in 2004-05. As a result, the all-India incidence of poverty according to the Tendulkar Committee is also much more than that estimated in the 61st round.

In the light of the new methodology, the Tendulkar Committee recommended re-estimation of poverty for previous years. An exercise was carried out by the Committee for 1993-94 to facilitate a broad two-point comparison of changes in headcount ratios. By this exercise, ***poverty at all-India level in 1993-94 was found to be 50.1 per cent in rural areas, 31.8 per cent in urban areas, and 45.3 per cent in the country as a whole.*** A comparison with data presented in Table 15.2 shows that the incidence of rural poverty in 1993-94 was much larger according to the Tendulkar Committee than what the official estimates suggest.

While the incidence of rural poverty estimated by the Tendulkar Committee as compared with the official estimates was much more both in 1993-94 and 2004-05, ***the extent of poverty reduction is found to be almost similar. For instance, while rural poverty declined from 37.3 per cent in 1993-94 to 28.3 per cent in 2004-05 according to the old methodology, it declined from 50.1 per cent in 1993-94 to 41.8 per cent according to the Tendulkar Committee.***

Poverty Estimates Based on 66th Round of NSSO

On March 19, 2012, the Planning Commission released the estimates of poverty for the year 2009-10 computed from the 66th Round NSS (2009-10) data on Household Consumer Expenditure Survey. ***The poverty line was defined as ₹ 22.40 per capita per day in rural areas and ₹ 28.60 per capita per day in urban areas (this translates to ₹ 672.80 per capita per month in rural areas and ₹ 859.60 per capita per month in urban areas). On this basis, 29.8 per cent of the population was below the poverty line in 2009-10 (33.8 per cent in rural areas and 20.9 per cent in urban areas).*** This shows a 7.4 percentage point fall in all-India poverty ratio over the five-year period 2004-05 to 2009-10 (8 percentage point fall in rural poverty and 4.8 percentage point fall in urban poverty). However, critics have pointed out that the poverty line was deliberately defined at a ridiculously low level in a bid to prove that the levels of poverty in the economy are declining. Moreover, as pointed out by Himanshu, the estimates released by the Planning Commission for the year 2009-10 are not comparable with the previous estimates by the Tendulkar Committee simply because the measure of consumption expenditure on which these correct poverty lines were applied to obtain the poverty estimates are not the same. The difference arises because in the 66th Round, the NSSO had imputed values to some items that households receive free, notably from employers. The earlier definition of private consumption expenditure excluded such items.

Himanshu has shown that if government expenditure on free meals (under mid-day meal programme) is excluded to make the poverty estimates comparable with those of the 2004-05 estimates, the 2009-10 poverty ratio increases from 29.8 per cent (33.8 per cent rural and 20.9 per cent urban) as posted by the Planning Commission to 31.5 per cent (35.2 per cent rural and 21.5 per cent urban). This means that ***the total number of poor in the country in 2009-10 was 373 million — 18 million more than the reported estimate of 355 million for the country as a whole.*** In other words, the number of poor people declined not by 52 million as claimed by the Planning Commission but by 34 million — *i.e.*, a third less than the decline claimed by the Planning Commission.[4]

Poverty Estimates Based on 68th Round of NSSO

On July 22, 2013, the Planning Commission released the estimates of poverty for the year 2011-12 computed from the 68th Round of NSSO (2011-12) data on Household Consumer Expenditure Survey. ***The poverty line has been defined at ₹ 27.20 per capita per day for rural areas and ₹ 33.33 per capita per day for urban areas (this translates to ₹ 816 per capita per month in rural areas and ₹ 1,000 per capita per month) in urban areas. On this basis, 21.9 per cent of the population was below the poverty line in 2011-12 (25.7 per cent in rural areas and 13.7 per cent in urban areas).*** In absolute terms, 269.8 million people were below the poverty line in 2011-12. However, these estimates were questioned by many critics who argue that the actual poverty ratio in the country is much higher than what these estimates convey. In the light of this criticism, the government appointed a Committee under the chairmanship of C. Rangarajan to re-examine the issue of poverty. The Committee submitted its Report to the government in June 2014. ***It defined the poverty line in 2011-12 at ₹ 47 per capita per day for urban areas and ₹ 32 per capita per day for rural areas. According to this definition, 29.5 per cent people in the country were below the poverty line to 2011-12***

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(30.9 per cent in rural areas and 26.4 per cent in urban areas). In absolute terms, 363 million people were below the poverty line in 2011-12. This shows that the number of people below the poverty line in 2011-12 was about 93 million more according to Rangarajan Committee as compared with the Planning Commission's estimate of 269.8 million.

World Bank Estimates of Poverty

World Bank earlier used to define poverty line at $ 1.25 per capita per day (at 2005 prices on purchasing power parity basis). Presently, it defines poverty line at $ 1.90 per capita per day (at 2011 prices on purchasing power parity basis). According to this definition, 31.1 per cent of the population in 2009 and 21.2 per cent of the population in 2011 was below the poverty line.

Limitation of the Head-count Non-discriminatory Approach

All the estimates of the incidence of poverty which we have considered above are based on the head-count which is peculiarly non-discriminatory. The poverty line once determined (on whatever criterion whatsoever) remains quite insensitive to the plight of the people suffering from various degrees of poverty. Let us for example consider the poverty line drawn for the rural population at ₹ 77 per month at 1979-80 prices. This poverty line is completely insensitive to whether a person is getting ₹ 76 or ₹ 25, but in terms of agony of the person the two situations are not the same. Obviously if a person receives ₹ 25 per month, his agony will be far more acute than in the case he receives ₹ 76 per month.

Amartya Sen has argued, "The poor is not an economic class, nor convenient category to use for analysing social and economic movements. Poverty is the common outcome of a variety of disparate economic circumstances and a policy to tackle poverty must, of necessity, go beyond the concept of poverty. The need for discrimination is essential."[5] ***Thus, the analysis of poverty is to be conducted in two stages. In the first stage, it has to be sorted out who got how much and then by using some norm of income per head the poor can be identified. In the second stage, we should attempt "to decide how 'bad' the situation really is, and whether one situation is more outrageous than another."*** In this context, Sen asserts, ***"It is not sufficient to know how many poor people there are, but how exactly poor they are."***

Poverty Line or Destitution Line?

The definitions of poverty line adopted by the Planning Commission, Tendulkar Committee and Rangarajan Committee define poverty at very low levels which do not guarantee anything above a bare minimum. According to Jean Dreze, "Poverty line standards were set decades ago, at a time when even bare subsistence was far from assured for a large majority of the population. The poverty line is, of course, regularly updated for price increases, but not for the enhanced requirements of dignified living".[6] He, accordingly, points out that the poverty line, as defined in India, is actually a destitution line.

In a recent paper, Sudipto Mundle has pointed out that it is quite reasonable to argue that in the prevailing conditions in India, a family of five (which is the average household size) would not be able to survive on an income less than ₹ 10,000 per month, i.e., less than ₹ 67 per head per day. On an income of upto ₹ 20,000 per month, or ₹ 133 per head per day, such a family might just about manage to make ends meet. But the slightest negative stock, an illness, temporary loss of job, etc. would push it beyond the brink. For a family of five, ₹ 50,000 per month or ₹ 333 per head per day, may be considered the minimum they would need to live a decent life. The latest Annual Employment-Unemployment Survey Report published by the Labour Bureau (for the year 2016) points out that in ***2015-16, about 85 per cent of India's workers earned less than or upto ₹ 10,000 a month.*** Only 0.5 per cent workers earned ₹ 50,000 or more. About 54 per cent of the households surveyed had only one earning member, and another 31 per cent had only two earning members. Thus, arguably, ***the majority of our worker households still live on the margin of survival of ₹ 20,000 per month or less.***[7]

MULTIDIMENSIONAL POVERTY

Because of the controversies surrounding the definition of poverty lines based on calorie or expenditure norms, and the ease with which the government can manipulate these lines to show that the levels of poverty are declining, many economists have in recent years been advocating the abandonment of the very idea of such poverty lines. For instance, N. Krishnaji has recently argued that ***a single poverty line based on a calorie or expenditure norm is bound to be arbitrary depending wholly on who is setting up this line.***[8] Moreover, such a line cannot take into account the various dimensions of poverty. This is clear from the fact that while income does focus on an important dimension of poverty, it gives only a partial picture of the many ways human lives can be blighted. As noted by the *Human Development Report 1997*. "Someone can enjoy good health and live but be illiterate and thus cut-off from learning, from communication and from interactions with others. Another person may be literate and quite well educated but prone to premature death because of epidemiological characteristics or physical disposition. Yet, a third may be

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excluded from participating in the important decision-making processes affecting his/her life."[9] As is clear, the deprivation of none of these people can be fully captured by the level of their income. To get a complete idea of poverty, one has thus to enlarge the canvas of study and talk in terms of deprivations and not merely income as it is in the deprivation of the lives that people can lead that poverty manifests itself. ***Poverty is thus a denial of choices and opportunities for living a tolerable life.*** This is the concept of human poverty. It means that opportunities and choices most basic to human development are denied — to lead a long, healthy, creative life and to enjoy a decent standard of living, freedom, dignity, self-respect and the respect of others.

Human Development Report 1997 introduced a human poverty index (HPI) in an attempt to bring together in a composite index the different features of deprivation in the quality of life to arrive at an aggregate judgement on the extent of poverty in a community. The Report acknowledged that human poverty is larger than any particular measure, including the human poverty index. It includes many aspects like lack of freedom, inability to participate in decision making, lack of personal security, inability to participate in the life of a community and threats to sustainability and intergenerational equity, etc., which cannot be measured. However, given the fact that the issues of poverty in the developing countries involve hunger, illiteracy, epidemics and the lack of health services or safe water, ***the human poverty index*** constructed by the *Human Development Report* ***focused on the deprivation in the following three elements of human life — longevity, knowledge, and a decent standard of living.*** The *Human Development Report 2009* calculated HPI for 135 countries. India's rank in terms of this index was as low as 88. This clearly reflects this country's unsatisfactory performance in alleviating human poverty. In absolute terms the HPI is as high as 28.0 per cent, indicating that human poverty is widespread.

Multidimensional Poverty Index

Human Development Report 2010 introduced the concept of Multidimensional Poverty Index (MPI) to replace HPI. ***The MPI is the product of the multidimensional poverty head-count (the share of people who are multidimensionally poor) and the average number of deprivations each multidimensionally poor household experiences (the intensity of their poverty).*** It has three dimensions mirroring the HDI — health, education and living standards — which are reflected in 10 indicators. The maximum score is 100 per cent, with each dimension equally weighted (thus the maximum score in each dimension is 33.3 per cent). The education and health dimension have two indicators each, so that each component is worth 5/3 (or 16.7 per cent). The standard of living dimension has six indicators, so each component is worth 5/9 (or 5.6 per cent).

The two indicators for the education dimension are: *(i)* no household member has completed at least six years of schooling, and *(ii)* at least one school-age child (up to grade 8) is not attending school. The two indicators for the health dimension are: *(i)* at least one member is malnourished, and *(ii)* a child has died in the household within five years prior to the survey. The six indicators for the standard of living dimension are: *(i)* no electricity, *(ii)* no access to clean drinking water, *(iii)* no access to adequate sanitation, *(iv)* house has dirty floor, *(v)* household uses 'dirty' cooking fuel (dung, wood or charcoal), and *(vi)* household has no asset related to access to information (radio, TV, telephone) and no asset related to mobility (bike, motorbike, car, truck, animal cart, motorboat) and no asset related to livelihood (refrigerator, arable land, livestock).

To identify the multidimensionally poor, the deprivation scores for each household are summed to obtain the household deprivation c. A cut-off of 33.3 per cent, which is the equivalent of one-third of the weighted indicators, is used to distinguish between the poor and non-poor. ***If c is 33.3 per cent or greater, that household (and everyone in it) is multidimensionally poor. Households with a deprivation score greater than or equal to 20 per cent but less than 33.3 per cent are vulnerable to or at risk of becoming multidimensionlly poor. Households with a deprivation score of 50 per cent or higher are severely multi-dimensionally poor.***[10]

As stated above, the MPI value is the product of two measures: the multidimensional head-count ratio and the intensity (or breadth) of poverty.

The headcount ratio, H, is the proportion of the population who are multidimensionally poor:

$$H = \frac{q}{n}$$

where q is the number of people who are multidimensionally poor and n is the total population.

The intensity of poverty A, reflects the proportion of the weighted component indicators in which, on average, poor people are deprived. For poor households only, the deprivation scores are summed and divided by the total number of poor persons:

$$A = \frac{\sum_i^q c_i}{q}$$

where c_i is the deprivation score that the ith poor experiences.

The multidimensional poverty index is then given by

MPI = $H.A$.

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Table 15.5

Calculation of Multidimensional Poverty Index (MPI)

Indicators	*Household*				*Weights*
	1	*2*	*3*	*4*	
Household size	4	7	5	4	
Education					
No one has completed six years of schooling	0	1	0	1	5/3 or 16.7%
At least one school-age child not enrolled in school	0	1	0	0	5/3 or 16.7%
Health					
At least one member is malnourished	0	0	1	0	5/3 or 16.7%
One or more child have died	1	1	0	1	5/3 or 16.7%
Living conditions					
No electricity	0	1	1	1	5/9 or 5.6%
No access to clean drinking water	0	0	1	0	5/9 or 5.6%
No access to adequate sanitation	0	1	1	0	5/9 or 5.6%
House has dirty floor	0	0	0	0	5/9 or 5.6%
Household uses 'dirty' cooking fuel (dung, firewood or charcoal)	1	1	1	1	5/9 or 5.6%
Household has no access to information and has no assets related to mobility or assets related to livelihood	0	1	0	1	5/9 or 5.6%
Results					
Household deprivation score, *c* (sum of each deprivation multiplied by its weight)	22.2%	72.2%	38.9%	50.0%	
Is the household poor ($c > 33.3\%$)	No	Yes	Yes	Yes	

Note: 1 indicates deprivation in the indicator, 0 indicates non-deprivation.

To illustrate how MPI is calculated, consider a hypothetical example which focuses on four households with sizes given an 4, 7, 5 and 4. Information for these households is given in Table 15.5.

The weighted count of deprivation of the different households is obtained as follows:

Weighted count of deprivations in household 1:

$$\left(1\cdot\frac{5}{3}\right)+\left(1\cdot\frac{5}{9}\right)=2.22$$

which is equivalent to a deprivation score of 2.22/10 = 0.222, or 22.2 per cent.

Weighted count of deprivations in household 2:

$$\left(2\cdot\frac{5}{3}\right)+\left(1\cdot\frac{5}{3}\right)+\left(4\cdot\frac{5}{9}\right)=7.22$$

which is equivalent to a deprivation score of 7.22/10 = 0.722, or 72.2 per cent.

Weighted count of deprivations in household 3:

$$\left(1\cdot\frac{5}{3}\right)+\left(4\cdot\frac{5}{9}\right)=3.89$$

which is equivalent to a deprivation score of 3.89/10 = 0.389, or 38.9 per cent.

Weighted count of deprivations in household 4:

$$\left(1\cdot\frac{5}{3}\right)+\left(1\cdot\frac{5}{3}\right)+\left(3\cdot\frac{5}{9}\right)=5.0$$

which is equivalent to a deprivation score of 5.0/10 = 0.50 or 50 per cent.

Since $c > 33.3\%$ for three households (households 2, 3 and 4) they are classified as poor while one household (household 1) is not poor.

Members in the poor households are 7, 5, and 4.

Therefore, Head-count ratio *(H)*

$$=\frac{0+7+5+4}{4+7+5+4}=0.800$$

i.e., 80 per cent of people live in poor households.

Intensity of poverty *(A)*

$$=\frac{0.722\times 7+0.389\times 5+0.50\times 4}{7+5+4}=0.5625$$

(the average poor person is deprived in 56 per cent of the weighted indicators).

MPI = $H.A = 0.80 \times 0.5625 = 0.450$

Human Development Report 2018 presents estimates of multidimensional poverty index. The position of India is worrisome. This is clear from the fact that ***27.5 per cent of India's population (i.e., 36.4 crore people) suffers from multidimensional poverty. Moreover, 8.6 per cent of India's population suffers from 'severe poverty'.***

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Socio-Economic Caste Census (SECC) 2011

The first comprehensive exercise to estimate India's rural poverty levels was made by the Socio-Economic Caste Census (2011) whose report was released in July 2015. This Census identified a poor household on basis of assets and income and with this end in view, took into account the following seven-point deprivation indicators – *(i)* households with no more than one room, kutcha walls and roof, *(ii)* no adult member between 16 and 59 years, *(iii)* female heads of family with no adult male between 16 and 59 years, *(iv)* no able-bodied adult member and no literate member above 25 years, *(v)* scheduled castes, tribes and landless, *(vi)* no literate adult above 25 years of age, and *(vii)* landless households deriving major part of their income from manual labour. The following were automatically counted in the category of poor – households without shelter, destitute, beggars, manual scavengers, primitive tribes, and bonded labour. The total number of rural households in the country are 179.1 million (that is 883.83 million people). Of this ***31.26 per cent are poor***. This would imply that ***about 275 million people in rural areas live in 'deprivation'*** – a state of being where people struggle to eke out a day-to-day subsistence living.

Some other disturbing facts regarding rural poverty highlighted by the SECC 2011 are: *(i)* 23.7 million households live in one-room kutcha houses, constituting 13.25 per cent of the 179.1 million rural households, *(ii)* 53.7 million households (i.e., 30 per cent) own no land and are engaged in manual labour, *(iii)* 56 per cent of rural households have no land or property, *(iv)* 86.9 million rural households (*i.e.,* 48.5 per cent or almost half) are deprived on one or more of the seven counts listed above, *(v)* 74.5 per cent rural households have a highest earning member who makes less than ₹ 5,000 a month (in other words, the primary breadwinner in three out of four households in rural India earns less than ₹ 5,000 a month), and *(vi)* a staggering 92 per cent of rural households run on less than ₹ 10,000 a month.[11]

SAFETY NETS FOR POOR — POVERTY ALLEVIATION PROGRAMMES

The Earlier Phase — *Ad hocist* Approach

The strategy of direct assault on poverty through rural development and rural employment programmes was first adopted in the 1970s. With the Fifth Plan, poverty alleviation came to be accepted as one of the principal objectives of economic planning in this country. During the 1970s, a number of special programmes for the rural poor were undertaken of which the important ones were: Small Farmers' Development Agency (SFDA), Marginal Farmers' and Agricultural Labourers' Development Agency (MFAL), Drought-Prone Areas Programme (DPAP), Crash Scheme for Rural Employment (CSRE), Pilot Intensive Rural Employment Project (PIREP) and Food for Work Programme (FWP). None of these programmes comprehensively covered the whole country, though in certain parts of the country some of these programmes operated simultaneously for the same target groups. Apart from this territorial overlap, the major limitation of these programmes was that they were reduced to mere subsidy-giving programmes, lacking any planned approach to enable the rural poor achieve a higher level of income. The element of *ad hocism* in these programmes further reduced their effectiveness from the point of view of poverty alleviation. Hence, the need was felt for undertaking programmes which were not only far more comprehensive in coverage but could also make a direct assault on rural poverty.

The Latter Phase — Comprehensive Programmes

The Integrated Rural Development Programme (IRDP), the National Rural Employment Programme (NREP) and the Rural Landless Employment Guarantee Programme (RLEGP) were conceived keeping the objective of poverty alleviation in view. The ***IRDP*** was initially started in 1978-79 in 2,300 development blocks as a programme of total development. In the Sixth Plan, the IRDP was extended to the entire country. The NREP also commenced at the same time as part of the Sixth Plan and aimed at helping that segment of population which depended largely on wage employment and had virtually no source of income during the lean agricultural period. The ***RLEGP*** was launched on August 15, 1983 with the objective of expanding the employment opportunities for the rural landless. However, with a view to making the implementation of these wage employment programmes more effective, ***NREP and RLEGP*** were merged into a single rural employment programme since April 1, 1989. The merged programme was named ***Jawahar Rozgar Yojana (JRY).***

The ***IRDP*** conceived as anti-poverty programme aimed at helping the small and marginal farmers, landless labourers and artisans. It was thought by the planners that these people were poor because they possessed neither any productive assets nor any special skills. Therefore, the ***IRDP*** was designed to help the poor by creating new assets for them. These assets would include sources of irrigation, bullocks and implements besides inputs like seeds and fertilisers for farming, animals for dairy and other animal husbandry activities and tools and training for cottage industries and handicrafts. The basic strategy was self-employment of the poor with the help of these assets so that they manage to earn enough to rise above the poverty line. The skill endorsement aspect was covered under the ***Training***

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of Youth for Self-Employment (TRYSEM). The Programme Evaluation Organisation of the Planning Commission (PEO), the RBI, the NABARD and the Institute for Financial Management evaluated the performance of the ***IRDP*** at different points of time. The general conclusion that emerges from these studies is that the ***IRDP*** was not very effective as a poverty alleviation measure. However, it has now been restructured and renamed as ***Swarnajayanti Gram Swarozgar Yojana (SGSY)***. Moreover, certain allied programmes including TRYSEM have been merged into it. ***Employment Assurance Scheme (EAS)*** until it was merged into ***Sampoorna Grameen Rozgar Yojana (SGRY)*** in September 2001 provided 100 days of unskilled manual work to the rural poor seeking employment.

These poverty alleviation programmes suffered from various specific shortcomings which in Sandeep Bagchee's opinion were basically the result of "not taking into account the complexities of the environment, of having multiple and conflicting objectives instead of simplifying them by focusing on a single operational goal and designing a suitable and viable strategy on this basis."[12]

At present, special programmes for employment generation are being implemented both in rural and urban areas. All these programmes aim at poverty alleviation as well. The programmes for the rural poor include ***Swarnajayanti Gram Swarozgar Yojana*** (SGSY) and ***Sampoorna Grameen Rozgar Yojana*** (SGRY). ***The Nehru Rozgar Yojana*** (NRY) was launched in October 1989 for the benefit of the urban poor. It was merged into the ***Swarnajayanti Shahari Rozgar Yojana in 1997-98. Sampoorna Grameen Rozgar Yojana*** (SGRY) was launched in September 2001. ***Jawahar Gram Samridhi Yojana*** (JGSY) and ***Employment Assurance Scheme*** (EAS) were merged into it. ***SGRY*** aims at providing wage employment in rural areas as also food security. ***Mahatma Gandhi National Rural Employment Guarantee Scheme*** (MGNREGS) was introduced in February 2006. The Scheme aims to provide at least 100 days of guaranteed employment in a financial year to every household in the rural areas covered under the scheme and whose adult members volunteer to do unskilled manual work subject to the conditions laid down in the Act.

STRATEGY OF POVERTY ALLEVIATION

A careful examination of the poverty alleviation programmes reveals that the planners have made the assumption that the poor constitute a homogeneous category. The planners made no attempt to segment the group in terms of common characteristics and their requirements. According to Indira Hirway, a distinction has to be made between the two categories of poor, namely, those who have some skill and thus can take up self-employment and others who are to be provided with wage-employment. In her opinion each category should be treated separately by appropriate policy measures.[13] Nilakanatha Rath criticised the transfer of assets approach of the IRDP as largely misconceived. He favours a programme of creating wage employment on a massive scale.[14]

Hirway and Dantwala disagreeing with Rath strongly advocate that, in a programme for poverty alleviation, the role of self-employment should not be undermined. Self-employment is a major form of employment in the rural areas and this fact must not be ignored in the strategy of poverty alleviation.[15] Further, dependence on wage employment alone to tackle the problem of poverty will lead to total dependence of the poor on employers. It is also likely to accentuate the gap between the rich and the poor by strengthening the asset base of the former.[16] Therefore, ***the correct approach would be to incorporate both self-employment and wage-employment programmes in any poverty alleviation strategy.***

At present there seems to be little integration in transfer of assets and skills approach and employment approach. It is suggested that in future there has to be greater coordination between these two elements of poverty alleviation programme. The actual mix between the two will, however, depend on the circumstances prevailing in the particular region for which the micro level plan is prepared. A major limitation of the existing poverty alleviation strategy is that it has no programmes for those households who neither have assets nor skills and, in addition, do not have any able-bodied adult member and thus cannot benefit from wage-employment programmes. For such a category, separate policy measures would be required. Obviously these destitutes are to be covered under social security schemes.

Under the Seventh Plan, the basic emphasis was on productive employment rather than the alleviation of poverty. The programmes for poverty alleviation were viewed as supplementing the basic plan for overall growth. Therefore, in the Seventh Plan poverty alleviation was not in focus. The planners claimed that the Seventh Plan policies were formulated after a careful analysis of lessons from performance of various poverty alleviation programmes. The Seventh Plan aimed at reducing the percentage of the population below the poverty line from 39.9 per cent at the beginning of the Plan period to 28.2 per cent by 1990. However, as explained earlier in this chapter, there was only a modest decline in the incidence of poverty during the 1980s and early 1990s. This casts serious doubts on the correctness of the poverty alleviation strategy of that period.

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Elimination of poverty was one of the major objectives of the Eighth Plan. The planners had hoped to realise this objective by pursuing employment-oriented growth strategy. Hence, expansion of employment opportunities and augmentation of productivity and income levels of both the underemployed and unemployed poor were made the principal instruments for achieving this goal during the Eighth Plan. However, this strategy can show the required results only in the medium- and long-term. Therefore, under the Eighth Plan short-term employment was provided to the unemployed and underemployed poor through the special employment programmes. The Ninth Plan relied essentially on the trickle-down effects of economic growth for poverty alleviation. It nevertheless recognised the role of anti-poverty programmes and thus stated, "there is no cause to bring into question the utility or size of the anti-poverty programmes at the present time."[17]

The Tenth Five Year Plan sought to achieve a faster reduction in poverty rate by redressal of regional imbalances for which aggregate growth target was broken down State-wise. Thus, the Tenth Plan also like the Ninth Plan relied on the trickle-down effect of economic growth for poverty alleviation. The Eleventh Five Year Plan also emphasised rapid growth of the economy to achieve reduction in poverty. However, it emphasised that this growth must be better balanced to rapidly create jobs in the industrial and services sectors. According to the Plan, "This is necessary if a significant portion of the labour force is to shift out of agriculture where it is currently engaged in low productivity employment, into a non-agricultural activity that can provide higher real incomes per head."[18] Alongwith this, it will be necessary to improve the income earning opportunities of those people who remain in agriculture by raising land productivity. The Plan also emphasised the need to supplement the above programmes by 'targeted livelihood support programmes'.

The Twelfth Five Year Plan emphasises 'faster, sustainable and more inclusive growth'. According to the planners, while the objective of development is broad-based improvement in the economic and social conditions of our people, rapid growth of GDP is an essential requirement for achieving this objective.[19] Two reasons are cited in support of this contention. ***First,*** rapid growth of GDP produces a larger expansion in total income and production which, if the growth process is sufficiently inclusive, will directly raise living standards of a large section of the population by providing larger employment opportunities and other income enhancing activities. ***Second,*** rapid growth generates higher revenues which help to finance critical programmes of poverty alleviation and inclusiveness like Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS). Sarva Shiksha Abhiyan (SSA), Mid-Day Meals (MDMs), Integrated Child Development Services (ICDS), National Rural Health Mission (NRHM) etc. To ensure that growth is sufficiently inclusive, the Twelfth Plan emphasises: (*i*) faster growth in agriculture (especially in rainfed areas where most of the poor live); and (*ii*) faster growth in the manufacturing sector as a whole, including medium, small and micro enterprises sector (which will generate a much broader spread of employment and income earning opportunities). As far as the target for poverty reduction is concerned, the Twelfth Plan aims at reducing the head-count ratio of consumption poverty by 10 percentage points over the Plan period. It also aims at generating 50 million new work opportunities in the non-farm sector and provide skill certification to equivalent numbers over the Plan period.

Critical Evaluation of the Strategy for Poverty Alleviation

The strategy of poverty alleviation adopted by the Government of India suffers from the following limitations:

First, the income generation orientation of poverty alleviation programmes does not recognise the importance of increased flow of social inputs through family welfare, nutrition, social security and minimum needs programmes in alleviating conditions of poverty on a long-term basis.

Secondly, the programmes have done little for disabled, sick and socially handicapped individuals who cannot participate in normal economic activities. The strategy for poverty alleviation has also failed to do justice to women in intra-family distributions.

Thirdly, income and employment-oriented poverty alleviation programmes put additional income in the hands of the poor which they can use for buying food. But these programmes do not ensure that the poor can really manage to get adequate food all the year round for the family with the increased income, because this depends on the price, supply ease and time distribution of income.

Fourthly, the household approach focussed around self-employment enterprises or wage employment guarantees is not correct in the state of continuing demographic pressures and increasing smallness of the size of farm holding. G. Parthasarthy, therefore, stresses the need for reorienting poverty alleviation programmes to build-up what he calls 'group power': (*a*) for developing land and water resources, (*b*) for preventing perpetuation of exploitative practices, and (*c*) for channelising purchasing power (especially that of State) in favour of low income households.[20]

Fifthly, the present approach is nearly blind to the existence of secondary poverty which B. Seebohm Rowntre defines as a condition in which "earning would be sufficient for the maintenance of merely physical efficiency were it

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not that some portion of it is absorbed by other expenditure, either useful or wasteful such as drinking, gambling, inefficient housekeeping."[21] In India, a number of studies have shown that alcoholic addiction leads to malnutrition in a large number of cases.

Sixthly, the poverty line crossing criterion for evaluating the success of the poverty alleviation programmes is insensitive to the income changes occurring below poverty line. For overcoming this problem, A.K. Sen has suggested attaching of weights to various income slabs below poverty line.[22]

Seventhly, many rural poor depend on natural resources for their livelihood. However, the practices of using these resources are no longer viable and as a result they are fast deteriorating. The government should have taken into consideration the implications of this environmental decay which unfortunately it has not done.

Eighthly, the government has failed to make necessary changes in anti-poor laws and policies. These laws and policies harm particularly the tribals who depend on non-timber forest products for their subsistence and cash income.[23]

Finally, the poverty alleviation programmes often ignore the consequences of the earning activities of the poor in terms of occupational health hazards and adverse ecological consequences.

CONCLUSION

As stated earlier in this chapter, the international poverty line defined at $1.90 per capita per day shows that 21.2 per cent of India's population lives below the poverty line. The estimates of MPI show still higher levels of poverty. According to these estimates, 55.3 per cent of India's population (*i.e.,* 64.2 crore people) suffers from multidimensional poverty. These levels of poverty are much higher than those reported by the Planning Commission during the recent years. As shown earlier, MPI is a comprehensive measure of poverty as it includes various dimensions of poverty like years of schooling, child enrolment, mortality, nutrition, electricity, sanitation, drinking water, flooring, cooking fuel and asset ownership. Moreover, multidimensional poverty indicators have the advantage that they can either be aggregated to form a single index or disaggregated into separate dimensions. Policymakers can thus figure which dimension or dimensions is/are most responsible for poverty and deserve special attention.

However, turning a blind eye to this far superior method of poverty calculation, the Planning Commission continues to stick to its single poverty line based only on household consumer expenditure data. As noted by Prahlad Shekawat, this could be due to two reasons: (*i*) the arbitrary poverty line provides an excuse for the government to cap budget allocation for social welfare; and (*ii*) it also helps the government to claim that high growth trickles down, resulting in substantial poverty reduction.[24]

UNDP's research wing has analysed data for more than four decades to show that social and economic development happens due to systematic and effective investments in education, health and equitable living standards. Also, the global economic downturn and growing unemployment and inequities in recent times following the financial crisis in the Western countries has clearly exposed the fragility of the GDP-led endless growth model.

As Amartya Sen has been insisting for a very long time, high economic growth is meaningless as an end in itself and should be a means for achieving goals like education, particularly for girls, health, employment, equity, social justice and inclusive participation.

APPENDIX TO CHAPTER 15: UNIVERSAL BASIC INCOME (UBI)

The idea of an unconditional universal basic income (UBI) for everybody, rich or poor, has been around for quite sometime in the West. For India, it was first mooted by Pranab Bardhan in an article published in *Economic and Political Weekly* in March 2011 wherein he stated that ***"on the universalistic principle of social protection, one of the cleanest and least incentive-disruptive ideas, both ethically and economically compelling, is that of Universal Basic Income (UBI), under which everybody, rich or poor, gets an unconditional annual (or periodic) income supplement."***[25]

The idea has caught the fancy of a number of economists and decision-makers in recent times, so much so that the latest *Economic Survey* presented by the Government of India in Parliament on January 31, 2017 denotes a full chapter to it.[26] Discussion below is based primarily on this chapter unless otherwise stated.

The Conceptual/Philosophical Case for UBI

The concept of UBI is premised on the idea that a just society needs to guarantee to each individual a minimum income which they can count on, and which provides the necessary material foundation for a life with access to basic goods and a life of dignity. A universal basic income is, like many rights, unconditional and universal: it requires that every person should have a right to a basic income to cover their needs, just by virtue of being citizens. According to the *Survey,* the time has come to think of UBI for the following reasons:

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- **Social Justice.** UBI is, first and foremost, a test of a just and non-exploitative society. A society that fails to guarantee a decent minimum income to all citizens will fail the test of justice. In fact, no society can be just or stable if it does not give all members of the society a stake.

- **Poverty Reduction.** Conditional on the presence of a well-functioning financial system, ***a Universal Basic Income may simply be the fastest way of reducing poverty.*** UBI is also, paradoxically, more feasible in a country like India, where it can be pegged at relatively low levels of income but still yield immense welfare gains.

- **Agency.** The poor in India have been treated as objects of government policy. Our current welfare system inflicts an indignity upon the poor by assuming that they cannot take economic decisions relevant to their lives. As against this, an unconditional cash transfer treats them as agents. Moreover, UBI gives the freedom to the poor to allocate the cash received according to their own priorities regarding spending. Government is in no position to decide which risks of the different poor people need to be mitigated and how priorities are to be set.

- **Employment and Better Bargaining.** UBI is an acknowledgement that society's obligation to guarantee a minimum living standard is even more urgent in an era of uncertain employment generation. Moreover, UBI could also open up new possibilities for labour markets. UBI will also improve the bargaining power of workers as they will no longer be forced to accept any working conditions, just so that they can subsist.

- **Administrative Efficiency.** In India, in particular, the case for UBI has been enhanced because of the weakness of existing welfare schemes which are riddled with misallocation, leakages and exclusion of the poor.

Why Unversalise?

1. Saving in bureaucratic costs. According to *Economic Survey* 2016-17, there are about 950 Central sector and Centrally sponsored sub-schemes in India accounting for about 5 per cent of the GDP by budget allocation. If the States are also included, the number of schemes would be still larger. It is argued that considerable gains could be achieved in terms of bureaucratic costs and time by replacing many of these schemes with a UBI.

2. There is misallocation of resources in existing welfare schemes. The *Survey* has examined six top government welfare programmes – the PMAY (Pradhan Mantri Awas Yojana), SSA (Sarva Shiksha Abhiyaan), MDM (Mid Day Meal) Scheme, PMGSY (Pradhan Mantri Gram Sadak Yojana), MGNREGS (Mahatma Gandhi National Rural Employment Guarantee Scheme) and SBM (Swachh Bharat Mission) to estimate their targeting efficiency. The *Survey* finds that there has been considerable misallocation of resources under these programmes with the poorest areas of the country often obtaining a lower share of government resources when compared to their richer counterparts. Many districts in Uttar Pradesh, Bihar, Chattisgarh, parts of Jharkhand, eastern Maharashtra, Madhya Pradesh and Karnataka, among others, account for a large share of the poor and receive a less than equal share of resources.

Misallocation has repercussions for targeting of resources to the poor. It leads to 'exclusion error', i.e., genuine poor find themselves unable to access programme benefits. If a State or a district with more poor is allocated very little resources, then it is almost certain that some deserving households would be excluded. For instance, the *Survey* finds that despite accounting for more than half of the poor in the country, the States of Bihar, Madhya Pradesh, Rajasthan, Odisha and Uttar Pradesh, could access only one-third of the resources spent on the MGNREGS in 2015-16. This almost certainly implies that some deserving individuals are left out. An estimate of the exclusion error from 2011-12 suggests that bottom 40 per cent of the population are excluded from the PDS. The corresponding figure for 2011-12 for MGNREGS was 65 per cent.

How Can UBI Overcome These Issues?

1. UBI is likely to tackle misallocation. The UBI, by design, should effectively tackle issues related to misallocation. This is due to the reason that a UBI will simply amount to a transfer of resources from above and need not be 'accessed' by beneficiaries. The simplicity of the process cannot be overstated: ***beneficiaries are simply required to withdraw money from their accounts as and when they please, without having to jump through bureaucratic hoops.*** The simplicity of the process also implies that the success of a UBI hinges much less on local bureaucratic ability than do other schemes. In addition, by focussing on universality, UBI reduces the burden on the administration further by doing away with the tedious task of separating the poor from the non-poor.

2. Out-of-system leakage does not happen. Conceptually, ***a UBI reduces out-of-system leakage because transfers are directed straight to the beneficiaries' accounts.*** The scope for diversion is reduced considerably, since discretionary powers of authorities are eliminated almost wholly. Furthermore, UBI's expanded coverage will likely impact out-of-system leakage since the State is answerable to a larger section of its citizens. Finally, given the fewer avenues for leakages, monitoring a UBI would be easier than many other schemes.

Last mile concerns remain, however. Beneficiaries still need to access their bank accounts, either at local bank

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or post office branches or through BCs (Business Correspondents). In this context, *Survey* notes that the JAM (Jan Dhan, Aadhar, Mobile) system could eventually be used to provide funds to each individual directly into his or her account.

3. Reduces exclusion error. Given the link between misallocation and exclusion errors, a UBI that improves allocation of resources should mechanically bring down exclusion error. Furthermore, by virtue of being universal, exclusion errors under the UBI should be lower than existing targeted schemes.

The Cost of UBI

While many economists have come forward in support of UBI, concerns have been raised regarding its potential cost. The *Survey* estimates the UBI at ₹ 7,620 for 2016-17. The *Survey* assumes that in practice any programme cannot strive for strict universality, so it sets a target quasi-universality rate of 75 per cent (which the *Survey* refers to as *de facto* UBI). The economy wide cost is then the UBI number multiplied by 75 per cent. This yields a figure of 4.9 per cent of GDP. This should not be difficult to manage. However, as correctly pointed out by the *Survey*, the process of determining a UBI amount is not a one-time exercise: as the UBI is a cash transfer, its 'real' value tends to be determined by inflation in the economy. Over time, the same amount of cash transfer may not buy the same amount of goods. It is, therefore, important to index it to prices such that the amount gets revised periodically.

In his own estimates, Pranab Bardhan fixes the UBI at an inflation-indexed ₹ 10,000 at 2014-15 prices to be paid to each person per year in India's the then population of 1.25 billion. This comes to about 10 per cent of the Indian GDP that year. Bardhan estimates regressive subsidies that go to the better-off sections (the so-called 'non-merit' subsidies) at 9 per cent of GDP while the 'revenues foregone' in the Central budget (mostly in the form of tax holidays and exemptions) amount to about 6 per cent of GDP. Even if half of this 6 per cent of 'revenues forgone' is added to the regressive subsidies of 9 per cent, the total comes to about 12 per cent of GDP. Accordingly, Bardhan argues that UBI is fiscally not impossible to manage.[27]

However, as correctly pointed out by *Survey,* taking away subsidies to the middle class is politically difficult for any government. To tackle this problem, Bardhan argues that some more taxes will have to be levied (like the property taxes) and by replacing some egregiously dysfunctional current welfare policies.

Guiding Principles for Setting up a UBI

Implementing a UBI for a country as large and diverse as India is quite difficult and full of challenges. The *Survey* lays down three guiding principles that could help guide thinking in this direction.

1. *De jure* universality, *de facto* quasi-universality. To enable the exclusion of the obviously rich from the programme, a number of possibilities can be considered. The *Survey* lists the following four:

(i) Define the non-deserving based on ownership of key assets such as automobiles or air-conditioners or bank balances exceeding a certain size.

(ii) Adopt a 'give it up' scheme wherein those who are non-deserving choose to opt out of the programme just as in the case of LPG and are given credit for doing so.

(iii) Introduce a system where the list of UBI beneficiaries is publicly displayed; this would 'name and shame' the rich who choose to avail themselves of a UBI.

(iv) Self-targeting: Develop a system where beneficiaries regularly verify themselves in order to avail themselves of their UBI – the assumption here is that the rich, whose opportunity cost of time is higher, would not find it worth their while to go through this process and the poor would self-target into the scheme.

2. Gradualism. A guiding principle is gradualism: the UBI must be embraced in a deliberate, phased manner. A key advantage of phasing would be that it allows reform to occur incrementally – weighing the costs and benefits at every step.

3. UBI and redistributive resource transfers to States. A number of State governments receive large amounts of transfers that may not *prima facie* increase growth or consumption. The UBI offers a possible way around: a part of the redistributive resource transfers may be transferred by the Centre directly into beneficiaries' accounts in the form of a pilot UBI programme.

The Survey advocates the adoption of UBI in urban areas first, as these areas are less likely to suffer from poor banking infrastructure and lack of individuals with bank accounts.

Arguments against UBI

1. A common argument against UBI is that it will lead to work disincentives (as you get this income without any work). However, Bardhan feels that any feasible UBI for India in the foreseeable future will be so small that it will not significantly replace work. If anything, the poor are

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often overworked in back-breaking, oppressive work, and it will be better if they, particularly women, can work a little less. It can also be a great relief for the stark livelihood uncertainties faced daily by a large number of self-employed and the marginalised casual and migrant workers, and will help them in seeking better jobs. It will also enhance their bargaining power against the traders, middlemen, contractors, creditors and landlords they encounter.[28]

2. Another common argument against UBI is that the poor (particularly the poor in the household) will blow it up in alcohol and drugs and gambling. However, Bardhan points out that there is actually not much evidence of misuse of such grants in the accumulating experimental data. There are now many experiments in different parts of the world on the use of unconditional cash grants, which show that most of the money is found to be spent on worthwhile goods and services.

3. Another concern is: Should income be detached from employment? According to the *Survey,* the society already does this, but largely for the rich and the privileged. Any society where any form of inheritance or accepting non-work related income is allowed, income is already detached from employment. So, receiving a small unearned income as it were, from the State, should be economically and morally less problematic than the panoply of 'unearned' income our societies allow.

4. There are people who argue that the proposal of UBI for India is not politically feasible. Bardhan argues that although this argument is true to an extent, the idea of UBI is worth a try. It is necessary to mobilize public opinion and activate social movements in its favour. As pointed out by *Survey,* "It is important that UBI is not framed as a transfer payment from the rich to the poor. Its basis is rather different. UBI gives concrete expression to the idea that we have a right to a minimum income, merely by virtue of being citizens. It is the acknowledgement of the economy as a common project. This right requires that the basic economic structure be configured in a way that every individual gets basic income."[29]

NOTES

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16 Chapter

INCOME INEQUALITIES IN INDIA

In order to understand the impact of development exercise on the economic welfare of the people in a proper perspective, economists generally investigate how the gains of economic growth in a developing country are distributed, which economic groups benefit from the increase in income and if over the years distribution of income fails to improve, then what are the causes for disequalising growth. In this chapter, we shall be explaining basic issues related to income distribution in our country. More specifically, we shall address the following issues:

- The extent of income inequalities in India
- Causes of income inequalities in India
- Government policy and measures — policy options and areas of intervention.

INCOME INEQUALITIES IN INDIA

During the last few years, India has emerged as one of the fastest growing major economies of the world. However, what is a matter of concern is the fact that income inequalities have increased considerably with the top rich section of the population cornering most of the benefits. This is vividly brought out by the various studies on income inequalities conducted by different researchers and institutions in recent period. We present the result of some of these studies in this section. Due to the differences in data sources, years of comparison and methodology adopted, and also due to the fact that some measure inequalities in income while some measure inequalities in wealth, results of these studies differ from one another. However, all of them reach the conclusion that the income/wealth inequalities in India have increased considerably during the economic reforms period, especially during the last few years. All the gains of growth have accrued to a minuscule rich of the population while the majority continues to live in abject poverty.

The Study of Lucas Chancel and Thomas Piketty, 2017. The celebrated author of the classic work *Capital in the Twenty First Century*, Thomas Piketty has brought out a well researched and a comprehensive study on income inequalities in India for a very long period of time spanning a period of more than nine decades in collaboration with his colleague Lucas Chancel from Paris School of Economics. The study entitled "Indian Income Inequality 1922-2014: From British Raj to Billionaire Raj?" was published in July 2017.[1] Chancel and Piketty take into account the income tax data, NSSO household surveys data and national accounts data to study the extent of income inequalities in India. The main results of their study are as follows:

1. ***The share of national income accruing to the top 1 per cent income earners is now at its highest level since the creation of the Indian income tax in 1922.*** In other words, the current income inequality in the country is worse than it was before Independence. The top 1 per cent accounted for 20.7 per cent income in 1939-40 (the highest level recorded in the pre-Independence period). After this, the top 1 per cent saw their share in total income dip, reaching a low of 6.2 per cent in 1982-83. However, since then, their share in national income started rising again and ***reached a level of as high as 21.7 per cent in 2013-14.***

2. ***From 1980 to 2014, the top 1 per cent captured 29 per cent of total growth, as much as the bottom 84 per cent put together.***

3. The income threshold to enter the top 1 per cent category was ₹ 12.26 lakh in 2014, while the average income of this group was ₹ 30.9 lakh ***which is about 22 times the national average.*** Real incomes of this group have grown at an average of 6.7 per cent per annum from 1980 to 2014.

4. ***The share of the super-super rich (the top 0.1 per cent) has risen to 8.6 per cent in 2013-14,*** up from a low of 1.7 per cent in 1982-83, with their real incomes growing at 7.92 per cent per annum over the past three-and-a-half decades. These 8,00,000 individuals who comprise the top 0.1 per cent, captured more growth (12 per cent) than the bottom 50 per cent put together (11 per cent) over the period 1980-2014. This is considerably worse than the situation in China where the top 0.1 per cent captured 6 per cent of total national income growth over the said period.[2]

5. ***Cumulatively, the top 10 per cent now account for 55 per cent of all income.*** On the other hand, the share of the middle 40 per cent has fallen to a historic low of 29.6 per cent. The deterioration in the distribution can be seen from the fact that in 2000, the top 10 per cent and the

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middle 40 per cent captured exactly the same amount of income.

6. ***The bottom 50 per cent***, whose share had risen from 19 per cent in 1955-56 to a high of 23.6 per cent in 1982-83, ***accounted for only 14.9 per cent of income in 2013-14.***

7. Per capita incomes of the top 10 per cent grew at an average of 4.96 per cent per annum from 1980 to 2014, while those of the middle 40 per cent grew by 2.02 per cent per annum; and those of the bottom 50 per cent grew by only 1.94 per cent per annum.

8. ***The average income of an adult in the top 1 per cent was 70 times the average of the bottom half and 35 times that of the middle 40 per cent.***

World Inequality Report 2018. The *World Inequality Report* 2018 was released on December 14, 2017 by World Wealth and Income Database which tracks information on income distribution across the world. The report was coordinated by economists Facundo Alvaredo, Lucas Chancel, Thomas Piketty, Emmanuel Saez and Gabriel Zucman and shows unequal impacts of globalisation in the world over the past 40 years. As far as India is concerned, the Report reproduces the results of the Report prepared by Lucas Chancel and Thomas Piketty considered above and points out that ***the inequality in India has risen substantially from the 1980s onwards, following profound transformations in the economy that centered on the implementation of deregulation and opening-up reforms.*** This is clear from the fact that ***since the beginning of deregulation policies in the 1980s, the top 0.1 per cent earners have captured more growth than all of those in the bottom 50 per cent combined.*** The middle 40 per cent have also seen relatively little growth in their incomes. According to the Report, "this rising inequality trend is in contrast to the thirty years that followed the country's Independence in 1947 when income inequality was widely reduced and the incomes of the bottom 50 per cent grew at a faster rate than the national average".[3] However, ***by 2014, the national income share of the bottom 50 per cent was just two-thirds of the share of the top 1 per cent, who totalled 7.8 million.*** According to the Report, "These evolutions are consistent with the dynamics of Indian wealth inequality, which exhibit a strong increase in the top 10 per cent wealth share in the recent period, in particular after 2002. "Highly unequal income growth at the top mechanically drives wealth inequality across the population, which in return fuels income concentration".[4]

Global Wealth Reports by Credit Suisse. According to the report on Global Wealth released by Credit Suisse in November 2016, ***the share of the top 1 per cent in the country's wealth rose from 36.8 per cent in 2000 to as high as 58.4 per cent in 2016.*** In fact, inequalities have increased considerably in recent years. For example, the share of the top 1 per cent in country's wealth which was 40.3 per cent in 2010 rose to 58.4 per cent in 2016. Over the same period, the share of the top 10 per cent in country's wealth increased from 68.8 per cent to 80.7 per cent. The fate of the poor would be clear from the fact that the bottom half of the population owned a mere 2.1 per cent of the country's wealth in 2016.[5]

According to Global Wealth Report by Credit Suisse released in November 2017, the acceleration in wealth creation in India has not been uniform. ***Nine out of every 10 adults have wealth below $ 10,000.*** Indeed, the median wealth per adult is as low as $ 1,295. At the other extreme, ***just 0.5 per cent of adults (about 4.2 million) have a networth over $ 1,00,000.*** According to Credit Suisse estimates, 1,820 adults have wealth over $ 50 million and 760 have more than $ 100 million.[6]

Oxfam Report, 2018. In its Report titled "Reward Work, Not Wealth" released by Oxfam International in January 2018, it is observed that ***during 2017, the richest 1 per cent of the people cornered as much as 73 per cent of the national income generated in the country.*** As against this, 670 million Indians, who comprise the poorest half of the population saw just 1 per cent increase in their wealth. In 2016, 58 per cent of national income went to India's richest 1 per cent.

The Report also points out that the wealth of India's richest 1 per cent increased by ₹ 20,913 billion during 2017 – an amount equivalent to the total budget of the Indian government for the year 2017-18.

India added 17 new billionaires in 2017, taking the total to 101. Indian billionaires' wealth rose by ₹ 4,891 billion in 2017 – from ₹ 15,778 billion to over ₹ 20,676 billion – ***making the country one of the most unequal in the world.***[7]

CAUSES OF INCOME INEQUALITIES IN INDIA

The foregoing evidence candidly shows that there are glaring income inequalities in India. The main reasons for these inequalities are as under:

1. Inequalities in land ownership and concentration of tangible wealth in the rural sector. There was concentration of landed property in India during the British period on account of the zamindari system. The zamindari system was abolished immediately after Independence, yet the concentration of land ownership could not be broken.

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Even as late as in 2010-11, 67.1 per cent of total operational holdings were marginal holdings (less than one hectare in size) but area operated under them was just 22.5 per cent (with average holding size being just 0.39 hectare). If we consider marginal and small holdings together (with area less than 2.0 hectare), we find that as many as 85.0 per cent holdings in 2010-11 fell in this category but they operated only 44.6 per cent area. As against this, large holdings (area 10 and above hectares) were only 0.7 per cent of the total holdings but operated 10.6 per cent of the total cultivated area (average size of such holdings being as large as 17.38 hectares). Almost all experts are of the view that the major cause of income inequalities in the rural sector is the concentrated ownership of land and other assets.

2. Concentration of assets in private corporate sector. There is an extreme concentration of economic wealth and power in the hands of large industrialists and they have succeeded in acquiring massive assets over time. They have been aided in their efforts by the easy availability of finance from banks and other financial institutions, besides equity capital which they raise from the market. In fact, with increasing facilities and growth opportunities being provided to the large industrialists in the period of economic reforms (*i.e.*, the period since 1991), tendencies of increasing concentration of wealth and economic power have been further strengthened. For instance, as on March 31, 1995, the 10 largest private industrial companies had aggregate assets worth ₹ 45,830 crore. As against this in 2016-17, Reliance Industries (the largest private sector company) alone had assets worth ₹ 4,92,562 crore. The top 5 private sector companies (in terms of assets) in this year were Reliance Industries, Bharti Airtel, Tata Motors, Larsen and Toubro, and Vedanta and their combined assets were as large as ₹ 11,33,786 crore.[8]

3. Rising capital intensity of technology. With massive changes in technology taking place over the years (particularly in the field of information technology), there has been a significant shift of demand in favour of capital *vis-a-vis* labour, thereby raising the share of profits relative to wages. It has also shifted demand in favour of more skilled workers relative to less skilled workers, thereby raising wage differential between skilled work, including the work of managers, and unskilled work. Both these trends have, in turn, raised inequality.

4. Inflation and the price rise. Inflationary pressures have accentuated in the economy over the years eroding the real income of the working class, while the industrialists, traders, and farmers with large marketable surplus have benefited a great deal from this process. In India, very little has been done to offset this redistributive effect of inflation, and as a result it has greatly increased income inequalities.

5. Inequity in credit facilities. In India, there is inequity in credit facilities which accentuates the inequalities arising from an unequal distribution of wealth. Business firms and individuals having an access to the formal capital markets manage to obtain finance on very favourable terms, while vast mass of small and marginal farmers, agricultural labourers and artisans depend heavily on moneylenders who charge an exorbitant rate of interest and also exploit these poor people in a number of ways.

6. Urban bias in private investment. While 70 per cent of the population in this country lives in rural areas, about 70 per cent of private investment goes to industries in urban areas. Therefore, there is a distinct 'urban bias' in the pattern of private investment. This urban bias takes the form of highly mechanised projects in which the share of wages in value added is relatively low. Therefore, as noted by Keith Griffin, "the rate of employment creation in the capital-intensive sector is slow, sometimes not even as fast as the rate of growth of the labour force."[9] This naturally leads to inequality in income distribution.

7. The role of the government. Though the State is often proclaimed as a 'precursor' and 'initiator' of economic change in India, the fact is that the State investment essentially plays a supportive role to private investment (especially the large and capital-intensive enterprises). This is due to the fact that the State depends for its support on the same social forces which own the wealth of the country and supply the technicians, administrators and the dominant political groups. In such an environment, the government merely guards the *status quo* and adopts policies which, on balance, are designed to perpetuate the hegemony of the propertied classes and those allied to them. Even the public expenditure policies in the field of social welfare, *i.e.*, health, education, social security and public housing help the relatively better off people more than they help the wretched poor belonging to the lowest income groups.

8. Economic reforms and liberalisation. Over the past four decades, the Indian economy has undergone profound changes. In the late 1970s, India was recognised as a highly regulated, centralised economy with socialist planning. But from the 1980s onwards, a large set of liberalisation and deregulation reforms were implemented. The process got a further boost in 1991 when macroeconomic stabilisation and structural adjustment programme was undertaken. In this period, tax rates were also brought down. These economic reforms placed the promotion of the private sector at the heart of economic policies, via denationalisations, disinvestment of public sector and deregulation (de-reservation and de-licensing of public companies and industries), ***weighing the economy substantially in favour of capital over labour***. According

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to *Wealth Inequality Report* 2018, these reforms were concomitant with a dramatic rise in Indian income inequality.[10]

GOVERNMENT POLICY AND MEASURES

In the earlier phase of economic planning, elimination of inequalities in income distribution was one of the proclaimed objectives of the government in this country. Plan documents and policy declarations of the State from time-to-time indicated various measures for reducing income inequalities. In this section, we discuss some of these measures and examine their impact on income inequalities.

1. Land reforms and redistribution of agricultural land. It is a well-known fact that income inequalities in the rural sector emanate mainly from the concentration of agricultural land. Before the abolition of the zamindari system most of the land belonged to the absentee landlords who appropriated a large portion of the agricultural production while the tiller of the soil got hardly enough for subsistence. Thus, legislative measures were undertaken to abolish landlords and other intermediaries and ceilings on holdings were fixed. Serious attempts to carry out these reforms would have broken the concentration of agricultural land. But unfortunately not only the legislative measures to carry out land reforms were inadequate and defective, their implementation was also scuttled at various levels. As a consequence, even now about 40 per cent of the agricultural land belongs to top 5.0 per cent of the rural households.

2. Control over monopolies and restrictive trade practices. Control of monopoly tendencies is considered necessary for reducing income inequalities. However, for more than two decades after this country got Independence virtually nothing was done to prevent the growth of monopolies. The Monopolies and Restrictive Trade Practices Act was passed as late as 1969. It was stated in the preamble of the Act that it would permit operation of the economic system only in the manner that the growth of monopolies resulting in concentration of economic power did not take place. The Act, thus, provided for control over monopolies and also for prohibiting restrictive trade practices. In case of business houses indulging in objectionable restrictive trade practices, their cases were to be handed over to the Monopolies and Restrictive Trade Practices Commission whose judgement would be binding on erring enterprises. In practice, these measures were found rather inadequate and ineffective. Not only this, the government further liberalised these measures on one pretext or the other. Even earlier, the industrial licensing machinery which was expected to protect and encourage small industries had failed. Both the Hazari Committee of the Planning Commission (1967) and the Dutt Committee of the Government of India had noted that the bigger industrial houses had utilised the licensing system to the detriment of small enterprises. ***Now with the increasing stress on liberalisation in the industrial sector and the increasing trends of consolidation, mergers and acquisitions, monopoly trends have further strengthened and economic disparities have increased.***

3. Employment and wage policies. Until the Fourth Five Year Plan, the employment objective was not taken seriously. T.N. Srinivasan has succinctly remarked that ***"employment schemes proposed in the plans were like frills added to their structure."***[11] However, since the beginning of the Fourth Plan some special programmes were undertaken such as the Crash Scheme for Rural Employment, the Drought Prone Areas Programme, self-employment schemes for engineers, employment schemes for educated unemployed, Food for Work Programme and so on. These programmes were short-lived as they were undertaken in an *ad hoc* manner. The Integrated Rural Development Programme (IRDP) was started in 1978-79 and extended to the entire country during the Sixth Plan period. The Integrated Rural Development Programme, the National Rural Employment Programme (NREP) and the Rural Landless Employment Guarantee Programme (RLEGP) aimed at providing employment to the rural poor with a view to eliminating poverty in the countryside. On April 1, 1989, the NREP and the RLEGP were merged into the Jawahar Rozgar Yojana. No doubt, these attempts were in the right direction, but the experience at the implementation level was very disappointing. The IRDP and allied programmes such as Training of Rural Youth for Self-Employment and Development of Women and Children in Rural Areas have been restructured into a single self-employment programme called Swarnajayanti Gram Swarozgar Yojana (SGSY) from April 1999. The JRY has been rechristened and renamed as Jawahar Gram Samridhi Yojana (JGSY) with effect from April 1999. The UPA government at the Centre introduced Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) in 2006. This is the most ambitious scheme introduced in the post-Independence period to alleviate poverty.

Role of statutory minimum wage in ameliorating the condition of the poor is limited in this country. In India, hardly 10 per cent of the working population is presently employed in the organised sector. The statutory wage provisions become unenforceable and ineffective, particularly in the countryside where agricultural labour is not only ignorant of law, but is also unorganised and oppressed. In contrast, the workers in the organised sector

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have been able to maintain, and in certain cases, even improve their incomes over the years.

4. Social security measures. Although the country does not have a comprehensive social security system, yet there are some social security provisions which are expected to help the workers in the organised sector. For example, the Workmen's Compensation Act entitles industrial workers to compensation in case of injury resulting in death, disability or disease while on duty. Similarly, the Maternity Benefit Act regulates the employment of women workers for certain periods before and after child birth and the Employees' Provident Fund Act entitles workers employed in organised industries to the benefit of provident fund. The most comprehensive social security measure, however, is the Employees State Insurance Act which entitles the insured workers to medical benefits, disability benefit, benefits for the period of sickness, maternity benefit and benefits to dependents. Undoubtedly, these social security measures are of great importance and their contribution in alleviating destitution in urban life is not small. Nonetheless, social scientists and other experts insist that ***unemployment dole and old age pension are the only measures which make a frontal attack on poverty and thereby reduce income inequalities. Unfortunately, these measures have not been introduced in India as yet.***

5. Minimum needs programme. Since the beginning of the 1970s, a very influential section of development economists has started asking for the pursuit of the minimum needs programme in developing countries. They assert that the benefits of growth do not automatically percolate downwards and thus less developed countries have no choice except to pay direct attention to the basic needs of the people at the lowest strata of the society. They further argue that it would be wrong to believe that there is necessarily a conflict between the two objectives, *viz.*, the basic needs and growth. Their assertion is that ***while ensuring of the fulfilment of the basic needs does not hinder economic growth, the reverse, as the experience in the various developing countries has proved, is not true.***[12] This approach influenced the planners in this country also. In the late 1970s and early 1980s the planners argued that the Minimum Needs Programme which was introduced in the Fifth Plan was not only directed towards the alleviation of poverty but also aimed at assisting economic growth. The *Sixth Five Year Plan* stated thus, "The programme is essentially an investment in human resources development. The provision of free or subsidised services through public agencies is expected to improve the consumption levels of those living below the poverty line and thereby improve the productive efficiency of both the rural and urban workers. This integration of social consumption programmes with economic development programmes is necessary to accelerate growth and to ensure the achievement of plan objectives."[13]

6. Programmes for the uplift of the rural poor. The hardcore of the poverty is to be found in the rural areas. The poorest sections in the rural areas belong to the families of landless agricultural labourers, small and marginal farmers, rural artisans, Scheduled Castes and Scheduled Tribes. ***In order to raise income of these categories of rural poor, broadly the following three types of programmes have been undertaken: (i) Resource and income development programme for the rural poor, (ii) Special area development programme, and (iii) Works programme for creation of supplementary employment opportunities.***

A number of programmes for the uplift of the rural poor falling in one category or the other have been introduced in the planning period. However, the programmes introduced earlier were often overlapping. They not only faced difficulties in effective monitoring and accounting but also lacked a clear perspective. "In practice, therefore, these programmes were reduced to mere subsidy giving programmes shorn of any planned approach to the development of the rural poor as an in-built process in the development of the area and its resources."[14]

The Sixth Plan intended to overcome these problems by undertaking one single integrated programme known as the Integrated Rural Development Programme (IRDP). This programme aimed at helping the rural poor in more than one way. But its major thrust was on the creation of productive assets for the vulnerable sections of the rural population. Since seasonal unemployment and underemployment are the major factors in rural poverty, a special programme known as the National Rural Employment Programme was conceived to eliminate unemployment in the countryside. The *Seventh Five Year Plan* claimed that the two anti-poverty programmes started under the Sixth Plan had considerably benefited the rural poor. On April 1, 1989 a comprehensive employment programme was adopted, and the NREP, the RLEGP and the Jawaharlal Nehru Rozgar Yojana were merged into it. The merged programme was named Jawahar Rozgar Yojana (JRY). The JRY has been restructured with effect from April 1999 and has been renamed as Jawahar Gram Samridhi Yojana (JGSY). At present some special programmes for the uplift of the rural poor are being implemented. Important programmes from this point of view are Swarnajayanti Gram Swarozgar Yojana and Sampoorna Grameen Rozgar Yojana. The most ambitious programme — Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) was launched in February 2006. These programmes for the uplift of the rural poor are

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expected to reduce income inequalities in the countryside besides alleviating poverty.

7. Taxation. Looking at the taxation structure and the degree of progression in the rates of direct taxes one gets the impression that the Indian tax system is progressive and has been designed to prevent concentration of wealth in a few hands. Is it really so? This question is difficult to answer. It requires information about the actual and not disclosed incomes. There is large undisclosed income of the people in the topmost income brackets which no economist can hope to know.

Amaresh Bagchi rightly asserts, "***The sharpness of progression in the nominal rates is, however, no guarantee of the redistributive effect of tax. Much depends on the extent to which the tax base comprehends the various ingredients of economic power.*** The base on which income tax is levied in India corresponds to what is called in the tax jargon a 'realised income' and is arrived at after allowing for all expenses of earning (subject to a few restrictions). In addition, the law allows numerous exemptions and deductions in order to promote various "non-tax" objectives. No systematic attempt has been made to examine how the Indian income tax base compares with a true index of the economic position of the tax payers such as the net accretion concept of income which is more relevant for judging the impact of taxes on the distribution of the command over goods and services in the community. Data required for such an enquiry are simply not available."[15] Thus, on the basis of superficial examination of the tax rates it would be wrong to claim that Indian tax system redistributes income in favour of the poorest sections of the society. ***Taxation of income on the basis of realisation, as is the practice in this country, does not touch the major source of inequality.***

To sum up, ***the various measures supposedly undertaken by the government have made little impact on poverty, and thus income inequalities perpetuate in their ugliest form.*** In this country, although rich and poor, literate and illiterate, men and women, all participate in electing the government, yet the power always remains in the hands of the capitalists, landlords and rich farmers. In fact, as pointed out by the *World Inequality Report* 2018, because of the transfer of public wealth into private hands, the capacity of the national governments to effectively tackle the problem of income inequality has considerably reduced in recent times. This is very much true in the case of our country as well. Under these circumstances, one should not expect any positive approach from the government for the elimination of economic disparities. However, if the employment generation programmes currently being undertaken by the government succeed, more employment opportunities are likely to be created. This might help somewhat in reduction of poverty. But, income inequalities are not likely to decline. They can decline only if strong and effective redistributive policies are implemented by the government. Such policies would include changes in distribution of assets, direct redistributive transfers, increased spending on health and education and creation of quality jobs and social safety nets for the poor and vulnerable.

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10. *World Inequality Report*, 2018, *op. cit.*, pp. 125-6.
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13. Planning Commission, *Sixth Five Year Plan* (New Delhi, 1981), p. 222.
14. *Ibid.*, p. 170.
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26 Chapter

INDUSTRIAL DEVELOPMENT DURING THE PLANNING PERIOD

Before the arrival of Britishers, India was industrially more advanced as compared to the economies of the West European countries. The Britishers systematically destroyed the industrial base of India. As a result, India inherited a weak industrial base, underdeveloped infrastructural facilities and a stagnant economy at the time of Independence. The government called an Industries Conference in December 1947 to consider ways and means to utilise the existing capacity more fully and to harness industry to the growing requirements of the people. The Conference was attended by the representatives of the Central and Provincial governments, industrialists and labour. To ensure better relations between management and employees, a tripartite agreement was entered into which provided for three-year industrial truce between the management and labourers. With the purpose of assisting industrial development, the government granted certain tax concessions to industry in 1948-49 and passed the Bill to establish the Industrial Finance Corporation of India. The industrial policy resolution was also passed in 1948. These factors had a favourable impact on industrial development. The official general index of industrial output (base 1946 = 100) registered an increase of 17.4 per cent over the period 1946 to 1951. In this chapter, we shall discuss:

- Programmes for industrial development under the plans
- Trends in industrial production during the period of planning
- Changes in industrial pattern during the plans
- Some problems of industrial development in India.

PROGRAMMES FOR INDUSTRIAL DEVELOPMENT UNDER THE PLANS

On the eve of the First Plan, the industrial development in India was confined largely to the consumer goods sector, the important industries being cotton textiles, sugar, salt, soap, leather goods and paper. Thus, ***the industrial structure exhibited the features of an underdeveloped economy.*** Industries manufacturing 'intermediate products' like coal, cement, steel, power, alcohol, non-ferrous metals, chemicals etc. were also established but their production was small as productive capacity was considerably below the requirements (except cement). As far as the capital goods sector is concerned, only a small beginning had been made. On the whole, while consumer goods industries were well-established, producer goods industries lagged considerably behind.

The First Plan did not envisage any large-scale programmes of industrialisation. Accordingly, ***only ₹ 55 crore out of the total expenditure of ₹ 1,960 crore in the First Plan (a mere 2.8 per cent) was spent on 'industry and minerals.'***[1] The Plan made an attempt to give a practical shape to the concept of mixed economy by providing for the development of both, the public sector and private sector, in a complementary manner.

The Second Plan accorded top priority to programmes of industrialisation as would be clear from the fact that the expenditure on industry and minerals was hiked to ₹ 938 crore under this plan which was 20.1 per cent of the total expenditure of ₹ 4,672 crore. Based on Mahalanobis Model, the Second Plan set out the task of establishing basic and capital goods industries on a large scale so that a strong base for industrial development in the future could be built. ***The strategy was spelt out in the Plan in the following words: "If industrialisation is to be rapid enough, the country must aim at developing basic industries and industries which make machines to make the machines needed for further development. This calls for substantial expansion in iron and steel, non-ferrous metals, coal, cement, heavy chemicals and other industries of basic importance..."*** Accordingly, such industries were given top priority in the industrial sector. Three steel plants of one million tonnes ingot capacity each were set up in the public sector at Bhilai, Rourkela and Durgapur besides the expansion and modernisation programmes undertaken in the private sector. Third Five Year Plan also pressed forward with the establishment of basic capital and producer goods industries — with special emphasis on machine building programme — so that the growth of the economy in the subsequent plans could become self-sustaining. As a result, programmes for expansion and diversification of capacity of the heavy engineering and machine building industries, castings and

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forgings, alloys tool and special steels, iron and steel and ferro-alloys, and steps to increase the output of fertilisers and petroleum products were undertaken. ***Expenditure on industry in the Third Plan was ₹ 1,726 crore which was 20.1 per cent of the total expenditure of ₹ 8,577 crore under the Plan.***

The above discussion shows that the Second and Third Plans placed great emphasis on building up the capital goods industries and basic industries. As a result, the industrial structure built up over these plans was heavily biased in favour of these industries. Most of these industries were set up in the public sector with the result that the size of the public sector also grew rapidly. The growth of the consumer goods industries was mostly left to the private sector. This structure of industrial development was promoted and nurtured in the Fourth and Fifth Plans also with minor changes here and there. ***Out of the total expenditure of ₹ 15,779 crore in the Fourth Plan, industry received ₹ 2,864 crore (i.e., 18.2 per cent of the total). The expenditure on industry was hiked to 22.8 per cent (₹ 8,989 crore out of the total of ₹ 39,426 crore) in the Fifth Plan.***

In a review of industrial development over the thirty years of planning, the Sixth Plan noted that industrial production had increased by about 5 times during this period. More important than this quantitative increase in output was the fact that the industrial structure had been widely diversified covering broadly the entire range of consumer, intermediate and capital goods. ***Expenditure on the industrial sector in the Sixth Plan was ₹ 15,002 crore which was 13.7 per cent of the total expenditure of ₹ 1,09,292 crore in the Plan.*** The period of the Sixth Plan saw wide range changes in the industrial policy of the government. The industrial and trade policies were substantially liberalised. As a result, industrial production started picking up but it also created certain distortions in the economy as the import-intensive sector of consumer durables and the group of chemicals, petrochemicals and allied industries marched much ahead of other sectors and groups of industries.

The overall outlay envisaged in the Seventh Plan for industrial and mineral programmes (as stated earlier, data on village and small-scale industries are excluded) in the public sector was ₹ 19,663 crore. As against this, ***the actual expenditure was ₹ 25,971 crore which is 11.9 per cent of the total expenditure of ₹ 2,18,730 crore in the Seventh Plan***. Industrial production was targeted to grow at the rate of 8.7 per cent per annum. The actual average rate of growth during the Seventh Plan works out at 8.5 per cent per annum. As far as the Eighth Plan is concerned, the overall outlay for industrial and mineral programmes in the public sector was kept at ₹ 40,588 crore. This was only 9.3 per cent of the total outlay of ₹ 4,34,100 crore in the Plan. This reduced allocation to industry and minerals in the Eighth Plan was in line with the liberalisation measures announced in the New Industrial Policy of 1991, according to which, the private sector is now destined to play an increasingly important role in industrial activities, especially in those fields where security and strategic or social considerations are not important. Data on actual expenditure on the industrial sector in the Eighth Plan reveal that ***the actual expenditure on industry during the Eighth Plan period was just ₹ 40,623 crore out of the total Plan expenditure of ₹ 4,85,457 crore. This comes to just 8.4 per cent of total expenditure under the Eighth Plan.***

The Ninth Plan outlay for industry and minerals was kept at ₹ 65,148 crore (the Ninth Plan allocations were made broad sector-wise, therefore this includes data on village and small-scale industries as well). This was 7.6 per cent of the total Plan outlay of ₹ 8,59,200 crore. However, ***the actual expenditure on industry and minerals in the Ninth Plan was only ₹ 40,408 crore which was just 5.0 per cent of total actual expenditure in the Plan***. The Ninth Plan envisaged an industrial growth rate of 8.2 per cent per annum while the actual growth rate was only 5.0 per cent per annum.

The Tenth Five Year Plan proposed an outlay of ₹ 58,939 crore for industry and minerals which was just 3.9 per cent of the total outlay of ₹ 15,25,639 crore. As against this, ***the actual expenditure on industry was ₹ 64,655 crore which was 4.0 per cent of actual expenditure under the Tenth Plan.*** This reduced allocation to industry is in line with the government's strategy to liberalise and privatise and give more space to the private sector to expand its activities. In this context, the following statement of the Plan is noteworthy, ***"The industrial development strategy is being re-oriented towards enabling our vibrant private sector to reach its full entrepreneurial potential, to contribute towards production, employment and income generation. Unless the economic environment is conducive to high levels of private sector participation, there can be little progress in accelerating industrial development and growth."***[2] The Plan set an ambitious target of 10 per cent per annum growth for the industrial sector whereas achievement was 8.2 per cent per annum. The Eleventh Five Year Plan proposed an outlay of ₹ 1,53,600 crore for the industrial sector which was 4.2 per cent of the total plan outlay of ₹ 36,44,718 crore (at 2006-07 prices).[3] Target for growth in the industrial sector was kept at 10 per cent per annum. The actual expenditure in the Eleventh Plan was ₹ 1,85,653 crore (at current prices) which was 5.1 per cent of total expenditure. The rate of growth of the industrial sector in this Plan was 6.9 per cent per annum. *The*

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Twelfth Plan proposed an outlay of ₹ 3,77,302 crore (at current prices) for the industrial sector which is 4.9 per cent of the total outlay of ₹ 76,69,807 crore.[4] Target for industrial growth was kept at 10 per cent per annum.

TRENDS IN INDUSTRIAL PRODUCTION

Industrial development during the period of planning can be divided into the following distinct phases: (*i*) Phase I which covered the period of the first three plans (*i.e.*, the period 1951 to 1965) laid the basis for industrial development in the future by building up a strong industrial structure; (*ii*) Phase II which covered the period 1965 to roughly 1980 was marked by industrial deceleration and structural retrogression; (*iii*) Phase III which covered the period of 1980s (1980-81 to 1990-91) was marked by industrial recovery; and (*iv*) Phase IV covering the post-reform period (*i.e.*, the period 1991-92 onwards).

Phase I (1951-65): Building up of Strong Industrial Base

As noted above, Phase I laid the basis for industrial development in the future. The Second Plan, based on Mahalanobis model, emphasised the development of capital goods industries and basic industries. Accordingly, huge investments were made in industries like iron and steel, heavy engineering, and machine building industries. The same pattern of investment was continued in the Third Plan as well. As a result, as shown in Table 26.1, ***there occurred a noticeable acceleration in the compound (annual) growth rate of industrial production over the first three Plan periods upto 1965 from 5.7 per cent in the First Plan to 7.2 per cent in the Second Plan and further to 9.0 per cent in the Third Plan***. What is significant from the point of view of long-run industrial development is the fact that the rate of growth of capital goods industries shot up considerably from 9.8 per cent per annum in the First Plan to 13.1 per cent per annum in the Second Plan and further to 19.6 per cent per annum in the Third Plan. Another important group of industries from the point of view of industrial development is 'basic industries'. The rate of growth of this group also registered a significant increase from 4.7 per cent per annum in the First Plan to 12.1 per cent per annum in the Second Plan and stood at 10.4 per cent per annum in the Third Plan. This shows that a strong base for industrial development was laid during the first three plan periods. The credit for this undoubtedly goes to the massive expansion of investment that took place in the public sector.

Phase II (1965-80): Industrial Deceleration and Structural Retrogression

As shown clearly in Table 26.1, ***the period 1965 to 1976 was marked by a sharp deceleration in industrial growth***. The rate of growth fell steeply from 9.0 per cent per annum during the Third Plan to a mere 4.1 per cent per annum during the period 1965 to 1976. It is also important to point out that even this meagre rate of industrial growth does not express the true situation as there was a sharp increase of 10.6 per cent in industrial production in the year 1976-77. If this year is left out, then the rate of industrial growth over the eleven-year period 1965 to 1976 declines further to a meagre 3.7 per cent per annum.[5] In a similar way, the rate of growth of 6.1 per cent per annum during the Fifth Plan owes considerably to the 10.6 per cent increase recorded in the year 1976-77. If this year is left out, the rate of industrial growth for the remaining four years comes down considerably. As is clear from Table 26.1, the last year of Phase II, *i.e.*, 1979-80, recorded a negative rate of growth of industrial production of –1.6 per cent over the preceding year.

Table 26.1

Annual Compound Growth Rates in Index Numbers of Industrial Production, 1951 to 1980

Use-based or Functional Classification	*1951 to 55 (4 years)*	*1955 to 1960*	*1960 to 1965*	*1965 to 1976*	*1974 to 1979 (Fifth Plan Average)*	*1979-80*
1. Basic Goods	4.7	12.1	10.4	6.5	8.4	– 0.5
2. Capital Goods	9.8	13.1	19.6	2.6	5.7	– 2.3
3. Intermediate Goods	7.8	6.3	6.9	3.0	4.3	1.9
4. Consumer goods	4.8	4.4	4.9	3.4	5.5	– 4.4
(a) Durables	—	—	—	6.2	6.8	5.6
(b) Non-durables	—	—	—	2.8	5.4	– 6.1
5. General Index (IIP)	5.7	7.2	9.0	4.1	6.1	– 1.6

Source: S.L. Shetty, "Structural Retrogression in the Indian Economy since the Mid-1960s", *Economic and Political Weekly*, Special Supplement, 1978, Table 4, p. 9 and Government of India, *Handbook of Industrial Statistics*, 1992, Table 50, p. 150 and Table 54, p. 155.

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In addition to the phenomenon of deceleration in industrial growth during the period 1965 to 1980, Table 26.1 also brings out clearly the phenomenon of structural retrogression that plagued the industrial sector during this period. From the point of view of long-run industrial development, the most important group of industries is the group of capital goods industries. This group registered a consistent and considerable increase from 9.8 per cent per annum in the First Plan to 13.1 per cent in the Second Plan and further to a phenomenal 19.6 per cent per annum in the Third Plan. However, in the next eleven years (1965 to 1976), the capital goods sector grew at an annual rate of only 2.6 per cent. If we consider the Fifth Plan period, the rate of growth of capital goods industries goes upto 5.7 per cent per annum but, as would be clear from Table 26.1, even this is substantially lower than the rates of growth recorded in the first three plans. The same story is found in the case of basic industries. In fact, as shown by S.L. Shetty, in the case of many industries of crucial importance, the growth between 1965-66 and 1976-77 was almost insignificant compared with the average from the previous five-year period.

Decline in the growth rate of capital goods industries and basic industries in the period after the Third Plan clearly represents the phenomenon of structural retrogression. Shetty also points out a second aspect of this structural retrogression. He shows that where growth has been moderately high, a majority of the industries belonged either directly or indirectly to elite-oriented consumption goods sector. This is illustrated by the disproportionately large increases in the output of man-made fibres, beverages, perfumes and cosmetics, commercial, office and household equipment, watches and clocks, and fine varieties of cloth.

Causes of Deceleration and Retrogression.[6] Several explanations were offered for the phenomenon of deceleration and retrogression in the industrial sector during Phase II. The government expressed the view that exogenous factors such as the wars of 1965 and 1971; drought conditions in some years; infrastructural constraints and bottlenecks; and the oil crisis of 1973 were responsible for slowdown of growth. K.N. Raj argued that low growth in the agricultural sector accounted for the slowdown of industrial growth by restricting the supply of raw materials on the one hand and by constraining the demand for industrial goods on the other hand. T.N. Srinivasan and N.S.S. Narayana argued that there was a considerable slackening of real investment in Phase II particularly in the public sector and this brought down the rate of growth in the industrial sector. A slightly different but more plausible version of the 'slackening of real investment' argument was presented by P. Patnaik and S.K. Rao according to whom there was a decline in public investment and this was followed by a decline in private investment as well due to 'the loss of stimulus' for investment. The essence of this argument is that a fall in public investment leads to a fall in private investment as well. Some economists like Deepak Nayyar, K.N. Raj and C. Rangarajan pointed to the relationship between income distribution, the demand factor and industrial growth. These economists pointed out that the market for industrial goods in the country is limited to the top 10 per cent of the population due to extreme inequalities of income and wealth. Once the demand for this section of the population gets saturated, there is no further expansion in demand. This limits the demand for consumption goods limiting, in turn, the demand for machinery and capital goods in subsequent stages. Some economists like Jagdish Bhagwati, Padma Desai, T.N. Srinivasan and Isher Judge Ahluwalia, blamed the wrong industrial policies, complex bureaucratic system of licensing, irrational and inefficient system of controls etc. for industrial deceleration.

Phase III (1981 to 1991): The Period of Industrial Recovery

The period of 1980s can broadly be termed as a period of industrial recovery. This is clearly brought out by a study of the revised Index of Industrial Production (base 1980-81). Rates of industrial growth based on this index are presented in Table 26.2. As is clear from this table, the rate of industrial growth was 6.4 per cent per annum during 1981-85, 8.5 per cent per annum during the Seventh Plan and 8.3 per cent in 1990-91. As noted by Vijay L. Kelkar and Rajiv Kumar, "This is a marked upturn from growth rates of around 4 per cent achieved during the latter half of 1960s and the 1970s. This performance is also an improvement upon the growth rates achieved during the First and Second Plan periods..."[7]

Similar trends of industrial recovery in 1980s are noted by some other economists as well. In her study spanning the period 1959-60 to 1985-86, Isher Judge Ahluwalia notes that the period 1980-81 to 1985-86 (*i.e.*, the first half of the 1980s) was "marked by significant acceleration in the growth of value added in the manufacturing sector and all its use-based sectors". The value added in the manufacturing sector grew at the rate of 7.5 per cent per annum in the first half of 1980s as against only 4.7 to 5 per cent per annum in the period 1966-67 to 1979-80.[8] According to Ahluwalia, a very important aspect of the growth revival during the first half of the 1980s was that it was not associated with an acceleration in the growth of factor inputs but was, rather, based on better productivity performance. Thus, total factor productivity which registered a negative and negligible growth of –0.2 to –0.3 per cent per annum in the period 1966-67 to 1979-80 showed a marked

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Table 26.2

Rate of Growth of Industrial Production (Use-based) During Phase III (Base 1980-81)

(per cent per annum)

Use-based or Functional Classification	*1981-85*	*1985-90*	*1990-91*
1. Basic Goods	8.7	7.4	3.8
2. Capital Goods	6.2	14.8	17..4
3. Intermediate Goods	6.0	6.4	6.1
4. Consumer Goods	5.1	7.3	10.4
(a) Durables	14.3	11.6	14.8
(b) Non-durables	3.8	6.4	9.4
General Index (IIP)	6.4	8.5	8.3

Source: Computed from Government of India, *Handbook of Industrial Statistics,* 1992, Table 50, p. 50 and Table 54, p. 155.

improvement in the first half of the 1980s when it registered a growth of 3.4 per cent per annum.

Causes of Industrial Recovery. The main causes of industrial recovery during 1980s are generally listed as follows:

1. New industrial policy and liberal fiscal regime. According to some economists, one of the main causes of industrial recovery during the 1980s was the liberalisation of industrial and trade policies by the government. According to Ahluwalia, "The most important changes have related to reducing the domestic barriers to entry and expansion to inject a measure of competition in domestic industry, simplifying the procedures and providing easier access to better technology and intermediate material imports as well as more flexibility in the use of installed capacity with a view to enabling easier supply responses to changing demand conditions."[9] These factors operating from the supply side were helped by the pursuit of what may be termed as a 'liberal fiscal regime.' The important features of liberal fiscal regime were: (*i*) maintenance of high budgetary deficits year after year; (*ii*) resort to massive borrowing often at high interest rates, and (*iii*) the encouragement of dissaving. All these aspects of liberal fiscal regime helped to expand the demand for manufactured goods in the economy.[10]

The above discussion shows that ***while liberal fiscal regime helped in generating demand for manufactured goods, liberal industrial and trade policies ensured that an adequate 'supply response' was forthcoming.***

2. Contribution of the agricultural sector. According to some economists, increased prosperity of large farmers in certain regions of the country helped in creating additional demand for industrial goods. According to R. Thamarajakashi, the rural sector's demand for non-agricultural consumer products rose considerably from 35 per cent in 1967-68 to 47 per cent in 1983. Not only this. There was a spurt in demand for a certain range of manufactured goods due to increase in the use of manufactured inputs per unit of cultivated area (or output). As shown by Thamarajakashi, the percentage of purchased inputs to total inputs (taken as a proxy for demand for industrial inputs in agricultural production) roughly doubled from 16.4 per cent in 1970-71 to 35.6 per cent in 1983-84.[11]

3. Growth of service sector. According to Dalip S. Swamy, there was a significant increase in government expenditure on all services in the 1980s. The consumption pattern of the service class is less food-intensive and more oriented towards durable consumer goods. Therefore, the consumption pattern of effective demand in 1980s changed in favour of consumer durable goods. As a result, argues Swamy, consumer durables were pushed to the "forefront of growth."[12] Fast growth of the consumer durable goods sector pushed up the rate of industrial growth.

4. The infrastructure factor. There was a marked resurgence in infrastructure investment in 1980s. As against only 4.2 per cent per annum increase in infrastructure investment during 1965-66 to 1975-76, the increase was as high as 9.7 per cent per annum during 1979-80 to 1984-85. Infrastructure investment rose further by 16.0 per cent in 1985-86 and 18.3 per cent in 1986-87. According to Ahluwalia, this revival of investment in the infrastructure sectors in the 1980s was also accompanied with a discernible improvement on the efficiency front.

Phase IV (The Period 1991-92 Onwards)

The year 1991 ushered in a new era of economic liberalisation. Major liberalisation measures designed to affect the performance of the industrial sector were — wide-scale reduction in the scope of industrial licensing, simplification of procedural rules and regulations, reductions of areas exclusively reserved for the public sector, disinvestment of equity of selected public sector undertakings, enhancing the limits of foreign equity participation in domestic industrial undertakings, liberalisation of trade and exchange rate policies, rationalisation and reduction of customs and excise duties and personal and corporate income tax, etc.

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A question that has engaged the attention of the economists in recent times is: what has been the effect of these liberalisation measures on the performance of the industrial sector in the post-reform period? To answer this question, consider the figures contained in Table 26.3 which compares the performance of the industrial sector during the pre-reform decade with the period since 1991.

For purpose of analysis, it is better to divide the post-reform period into two sub-periods: (*i*) the period of 1990s (upto 2001-02, *i.e.*, upto the end of Ninth Plan), and (*ii*) the period since 2002-03. The latter period consists of three sub-periods: Tenth Plan (2002-03 to 2006-07), Eleventh Plan (2007-08 to 2011-12) and Twelfth Plan (2012-13 to 2016-17).

The Period of 1990s. Important facts regarding industrial growth trends in the period of 1990s are as follows:

1. As is clear from Table 26.3, the rate of growth of industrial production in the Eighth Plan was 7.4 per cent per annum which was the same as the targeted rate of growth. Thus, the performance was satisfactory on this count.

2. The rate of growth of industrial production in the Ninth Plan was only 5.0 per cent per annum which was considerably less than the targeted rate of 8.2 per cent per annum. Thus, the performance of the industrial sector was highly unsatisfactory during the period of the second half of 1990s.

3. The industrial sector registered a dismal performance in the last year of the Ninth Plan, 2001-02, with its rate of growth being just 2.7 per cent. This is the worst performance of the industrial sector over the entire decade 1992-93 to 2001-02 excepting the year 1992-93 when the rate of industrial growth was 2.3 per cent.

4. ***The post-reform period (upto the end of Ninth Plan, i.e., the year 2001-02) was marked by considerable fluctuations and thus showed a total lack of consistency in industrial growth performance.*** Marked upheavals in different years were noted for all sub-sectors of industry – capital goods, basic goods, intermediate goods and consumer goods.

Causes of Unsatisfactory Industrial Performance in 1990s. The main causes for unsatisfactory performance of the industrial sector during the period of 1990s are as follows:

1. Exposure to external competition. According to the Planning Commission, the most important reason for lower growth rate during the Eighth Plan period as compared to the Seventh Plan period seems to be that "the industrial sector, which had been almost totally protected from both industrial as well as external competition during the previous four decades, was suddenly exposed to foreign competition through a significant liberalisation of imports and drastic reduction in import duties. The industry was hardly prepared for it and the slowdown was only to be expected...."[13]

2. Slowdown in investment. An important reason for the slowdown of industrial growth in 1990s was the slowdown of investment. It is a known fact that capital formation in the public and private sectors provides a stimulus for industrial growth in the form of both the direct demand or purchases that such expenditures involves, and

Table 26.3

IIP-based Growth Rates (Use-based) in Pre-Reform Decade and Post-Reform Period

Use-based or Functional Classification	*1980-81 to 1991-92**	*Eighth Plan** *1992-93 to 1996-97*	*Ninth Plan** *1997-98 to 2001-02*	*Tenth Plan** *2002-03 to 2006-07*	*Eleventh Plan** *2007-08 to 2011-12 (Base year 2004-05 = 100)*	*Twelfth Plan** *2012-13 to 2016-17 (Base year 2004-05 = 100)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
1. Basic Goods	7.4	6.8	4.1	6.6	5.4	3.9
2. Capital Goods	9.4	8.9	4.7	14.4	14.3	–3.7
3. Intermediate Goods	4.9	8.5	5.8	6.2	4.0	2.2
4. Consumer Goods	6.0	6.6	5.5	9.6	7.8	–0.1
(*i*) Durables	10.8	13.4	10.7	8.8	15.6	–1.2
(*ii*) Non-durables	5.3	4.8	3.8	10.0	3.4	1.1
General Index (IIP)	7.8	7.4	5.0	8.2	6.9	1.4

* Simple average of the annual growth rates.

Source: (*i*) For column (2), Government of India, *Economic Survey*, 2000-01, Box 7.1. p. 130; *(ii)* For columns (3) to (6), Reserve Bank of India, *Handbook of Statisitcs on Indian Economy* 2015-16 (Mumbai, 2016), Table 232, p 371; and *(iii)* For column (7), J. Dennis Rajakumar, "Comparising IIP and NPS in their New Incarnations", *Economic and Political Weekly*, September 30, 2017, Table 3, p. 79 and Table 4, p. 80.

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the indirect demand resulting from income generation by investments. However, ***consequent upon the adoption of the 'macro-economic adjustment' programme of the IMF in 1991, the Government of India was forced to cut down public expenditure drastically.*** Since there is a strong complementarity between public investment and private investment, a reduction in the rate of growth of real public investment had a depressing effect on private investment as well.

3. The infrastructural constraints. Perhaps the most important reason for unsatisfactory performance of the industrial sector was the deteriorating state of infrastructure. Industrial production suffered not only on account of inadequate availability of infrastructure like power and transportation bottlenecks, inadequate handling facilities at ports etc., but also due to 'poor quality' of infrastructure like frequent and unscheduled power breakdowns, poor road conditions, unduly long handling time at ports etc. All these factors added to the real costs of manufacture and thus adversely affected the competitiveness of domestic industry.

4. Difficulties in obtaining funds for expansion. Orderly development of capital market is an important condition for industrial growth because in its absence, the private sector capitalists will face difficulties in raising resources for expansion. The period since 1991 has witnessed two stock market scams — one in 1992 and the other in March-April 2001. These scams seriously eroded investor confidence. Subscriptions to IPOs (initial public offerings) fell drastically leading to a setback to the 'primary market.' Trading in stock exchanges (*i.e.,* 'secondary market') also fell. Because of this, capitalists found it difficult to raise resources from the capital market for funding their expansion plans. The performance of financial institutions turned worrisome as non-performing assets (NPAs) became quite large. Thus, the flow of funds from the financial institutions to the corporate sector was also not adequate.

5. Sluggish growth in exports. In a number of years during 1990s, exports grew at a very low rate. This was due to increasing competition in the international market on the one hand and inability of domestic industry to meet external competition by ensuring quality products, keeping to delivery schedule etc. on the other hand. The outbreak of the East-Asian crisis in mid-1997 compounded the problems for Indian exporters as there was a sharp depreciation in the external value of the currencies of this region. This made Indian exports uncompetitive in international markets as against the exports from countries belonging to the East-Asian region.

6. Anomalies in tariff structure. According to the Ninth Five Year Plan, there were anomalies in tariff structure leading to large-scale imports of second-hand machinery, basic materials and intermediate products. This adversely affected industrial growth in these sectors. In the case of fertiliser sector and refineries, while the finished capital goods enjoyed 'zero' rate of import duty, the domestic manufacturers were subject to taxes and duties and import duties on intermediates and components.[14]

7. Contraction in consumer demand. There was acute contraction in consumer demand in 1990s. Three distinct explanations can be offered to explain this contraction.[15] ***First,*** the rural purchasing power was severely affected by lower agricultural growth and increased fluctuations in growth in the 1990s. ***Secondly,*** Indian industry was faced with depressed purchasing power not only from the rural sector but also from the urban sector. The substantial wealth erosion caused by the fall in the equities and real estate markets also hampered the average urban consumer's proclivity to spend. ***Finally,*** there were distinct signs of growing inequalities in the distribution of income, and in the face of reduced employment growth as well as deterioration in the quality of employment, purchasing power in the hands of the vast masses of urban population possibly declined.

The Period Since 2002-03. As is clear from Table 26.3, ***the period of the Tenth Plan witnessed a revival of industrial growth with the average rate of growth increasing to 8.2 per cent (from just 5.0 per cent in the Ninth Plan).*** What is significant from the point of view of economic growth was the marked acceleration registered by the capital goods sector. The rate of growth of this sector averaged 14.4 per cent per annum over the Tenth Plan period and was as high as 18.2 per cent in the last year of the Plan, 2006-07. The continued robust expansion of the capital goods sector facilitated substantial capacity additions across a number of industries.

The average rate of growth of industrial production during the Eleventh Plan was just 6.9 per cent per annum as against the target of 10.0 per cent per annum. There were also wide fluctuations of industrial growth during different years of this Plan.

Based on an analysis of IIP growth over the period April 2006 to December 2011, *Economic Survey* 2011-12, arrived at the conclusion that ***all broad sectors of the IIP witnessed volatility in growth.*** IIP growth during April 2006 to December 2011 varied from –7.2 per cent to 20.0 per cent with a mean growth of 8.3 per cent and standard deviation of 6.5. ***While different sectors had different volatility spectrums, capital goods and intermediates were the most volatile.*** In fact, volatility of the manufacturing sector was largely on account of extreme fluctuations in growth in the capital goods and intermediate goods segments. In case of capital goods, growth varied from –26.5 per cent

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to 65.1 per cent with a mean growth of 18 per cent and standard deviation of 23.2.[16] ***High volatility in industrial growth (particularly in the growth of the capital goods sector and intermediate goods sector) creates industrial distortions and uncertainties and increases inflationary pressures in the economy.***

The performance of the industrial sector was quite unsatisfactory during the period of the Twelfth Plan. The rate of growth of industrial production in this Plan was just 1.4 per cent per annum (in fact, it was negative at –0.1 per cent in 2013-14 and stood at just 0.7 per cent in 2016-17). ***The main reason for the unsatisfactory performance of the industrial sector in the Twelfth Plan was the sharp decline in the investment activity.*** Several factors have contributed to the slowdown in investment activity. Rising costs and falling demand led to reduction in corporate profitability which, in turn, adversely affected the investment decisions of firms. Also, the slow pace of mega projects implementation and a decline in the number of new projects adversely impacted the capital goods sector. The consumer durable goods also showed a marked slowdown. As noted by *Economic Survey* 2013-14, the consumer durable goods sector in India is constrained by a limited domestic market owing to low per capita income. Another factor has been the major supply bottlenecks faced by core industries (which provide crucial inputs to the industrial sector).[17]

New Index of Industrial Production (Base 2011-12)[18]

The IIP has always been a key lead indicator of industrial output growth ever since its construction began on monthly basis decades ago. Accounting for the structural changes taking place within the sector, the CSO has been revising the IIP from time to time by enlarging the number of product items while excluding a few outdated items. As such, since its adoption for the first time with 1937 as the base year, the IIP has been revised nine times with change of base years to 1946, 1951, 1956, 1960, 1970, 1980-81, 1993-94, 2004-05, and more recently to 2011-12 (in May 2017). Apart from capturing the evolving structural changes with new weighting diagrams, the objectives of revising the index are to take into account new products and capture changes in quality of products, thus representing industrial growth in current basis.

The new IIP released by CSO in May 2017 has 2011-12 as base year. As pointed out by J. Dennis Rajakumar, the shifting to a new base was long overdue as the earlier series of IIP 2004-05 had suffered from outdated product basket and weighting diagram. Moreover, with national accounts and the Wholesale Price Index (WPI) shifting to base year 2011-12, it had become necessary to shift IIP also to base year 2011-12 to better align all data. The new IIP has 839 items and 407 item groups compared to 682 item and 399 item groups in the old IIP (with base year 2004-05). Such an increase in items and item groups can be entirely attributed to changes made in the coverage of manufacturing sector which has additional 189 items and eight item groups in the new series. The new series has been restricted to the organised sector with its weights being calculated only on the basis of organised manufacturing unlike in the 2004-05 series which covered weights for the unorganised sector also.

Analytical Groupings. The analytical groupings of IIP data continue in terms of use-based classification and eight core industries. The eight core industries in the 2011-12 series continue to be the same as the 2004-05 series, namely, coal, crude oil, natural gas, refinery products, fertilisers, steel, cement and electricity. In the use-based classification, a new category of "primary goods" has replaced the erstwhile category of "basic goods". Primary goods are said to be those which were "directly obtained from natural sources and used for further processing and consumption in manufacturing and power-generating activities." This has been done because the concept of "basic goods" has apparently suffered from definitional ambiguity and overlapped with other categories such as "intermediate goods". The scope of intermediate goods has been modified to include goods used as inputs in the production of other goods. The methodology of deriving production of capital goods has been changed to account for "work-in-progress". The break-up of consumer goods into self-explained durables and non-durables are reported as in the earlier series.

Another major change relates to the addition of a separate category of "infrastructure and construction goods". Items in this category have been picked up from diverse categories of the 2004-05 series, cement and rail materials (basic industries), cables (capital goods), bricks and tiles (consumer durables), and paints (consumer non-durables).

In respect of other use-based categories, while their nomenclatures have remained the same, their coverages have undergone some changes in the new series.

Table 26.4 provides information on growth rates (use-based) over the years 2012-13 to 2017-18 based on the new IIP.

A Comparison between Old and New Series[19]

The new IIP data (base year 2011-12 = 100) are available since 2011-12 and old IIP series (base year 2004 = 100) are available till 2016-17. This facilitates a comparison between the new and old series in different classificatory systems. The main results of this comparison are as follows:

1. Comparison of growth rates. The average industrial growth rate during the five year period 2012-13 to 2016-17

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Table 26.4

IIP-based Growth Rates (Use-based) 2012-13 to 2016-17 (Base Year 2011-12)

(per cent per annum)

Use-based or Functional Classification	*2012-13*	*2013-14*	*2014-15*	*2015-16*	*2016-17*	*Twelfth Plan** 2014-15 to 2016-17	*2017-18*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*
1. Primary Goods	0.5	2.3	3.8	5.0	4.9	3.3	3.7
2. Capital Goods	0.3	–3.7	–1.1	3.0	3.2	0.3	4.0
3. Intermediate Goods	5.1	4.6	6.1	1.5	3.3	4.1	2.3
4. Infrastructure/Construction Goods	5.4	5.7	5.0	2.8	3.9	4.6	5.6
5. Consumer Goods							
(i) Durables	4.9	5.6	4.0	3.4	2.9	4.2	0.8
(ii) Non-durables	6.1	3.7	3.8	2.6	7.9	4.8	10.6
General Index (IIP)	3.3	3.3	4.0	3.3	4.6	3.7	4.4

*Simple average of annual growth rates.

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Tables 231 and 232, p. 367.

works out to 3.7 per cent per annum in the new series in contrast to just 1.4 per cent per annum in the old series (see last columns of Table 26.3 and Table 26.4). In the latest year 2016-17, IIP growth of 0.7 per cent in the old series got revised to 4.6 per cent in the new series. Also, the annual growth rates had shown much larger fluctuations earlier than in the new series. This is reflected in the coefficient of variation of 87 per cent in the old series as against 16 per cent in the new series. Industrial growth rate in 2017-18 according to new series was 4.4 per cent.

2. Sectoral level. It is common to consider IIP growth under three sectors: mining, manufacturing and electricity. While there is some degree of correspondence in the two series for the electricity sector, the growth rates of mining and manufacturing are quite different in the two series. In particular, the divergence in the growth of manufacturing between the two series is glaring: the manufacturing sector's growth under the new series is much higher (ranging from 2.8 per cent to 4.8 per cent) than that in the earlier series (ranging from –0.8 per cent to +2.3 per cent).

3. Use-based classification. As noted earlier, some changes have been introduced in the nomenclature of use-based classification of industries. The erstwhile basic goods industries have been replaced with primary goods industries, and an entirely new group of 'infrastructure and construction goods industries' has been introduced. Therefore, we can discuss growth rates of capital goods, intermediate goods and consumer goods industries only which are broadly comparable in the two series. According to J. Dennis Rajakumar, this discussion leads us to the following results:

(i) The growth rate of capital goods industries in the new and old series moved in the opposite direction except in 2013-14, though with varying magnitudes. Capital goods industries appear to have performed better in the new series *vis-a-vis* the old series. However, as is clear from Table 26.4, their performance continues to be poor in the new series as well and this is a matter of serious concern.

(ii) The growth rate of intermediate goods in new IIP has remained higher than its corresponding growth in the old IIP by about 2 percentage points throughout.

(iii) Consumer goods industries, particularly consumer durable segments, exhibit divergent growth rates between the new and old series with growth under the new IIP remaining higher. Of these industries, primary goods and consumer durables exhibited steady growth in the new IIP series.

4. Core industries. Table 5 of J. Dennis Rajakumar's study presents a comparison of the growth rate of core industries in the new and old IIP. The main results that can be derived from a study of this Table are as follows:

(i) The growth rates of crude oil, natural gas and cement industries in the new and old series have moved in tandem with marginal differences on year-on-year basis. Both crude oil and natural gas have negative growth rates in both the series throughout (except 2017-18, when growth rate in the natural gas was 2.9 per cent). The growth rate of cement industry was almost the same in both series in all the years (positive in first four years by almost the same degree and negative in the fifth year, 2016-17, also by the same degree). However, production in cement industry rose by 6.3 per cent in 2017-18.

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(ii) In the case of refinery products, the growth rate was similar between the new and old series over the period 2013-14 to 2016-17. However, the growth rate in 2012-13 was significantly different (7.2 per cent in the new series and 28.9 per cent in the old series). The rate of growth for refinery products in the year 2017-18 was 4.6 per cent.

(iii) Growth of steel industry diverged between new and old series in 2012-13 and 2013-14, and of electricity and fertiliser in 2014-15 and 2015-16.

However, concludes Rajakumar, "there is no marked pattern *per se* across core industries in terms of differentials in growth under the new IIP and old IIP series". This implies that, ***the differences in the growth rate between the new and old IIP series have occurred in non-core industries.***

CHANGES IN THE INDUSTRIAL PATTERN DURING THE PLANS: A BRIEF RESUME

Important changes that have occurred in the industrial pattern during the period of planning are as under:

1. Increase in the share of industrial sector in GDP. The share of the industrial sector in Gross Domestic Product has slowly but consistently increased over the planning period. For instance, the share of industry (includes mining and quarrying, manufacturing, construction, electricity, gas and water supply) in GDP at factor cost increased from 16.6 per cent in 1950-51 to 27.7 per cent in 1990-91 and stood at 26.2 per cent in 2013-14. The new series on national accounts released by CSO in January 2015, presents data on GVA (gross value added) at basic prices with base year 2011-12. According to this series, ***the share of industry in GVA at basic prices was 31.5 per cent in 2016-17 and 31.2 per cent in 2017-18.***

2. Changing sectoral composition. As stated earlier, the three sectors in IIP are manufacturing, mining and electricity. ***In 1956, manufacturing had the highest weight with 88.85 per cent of the total.*** Though this sector continues to dominate the industrial scene, its weight has gradually come down to 75.53 per cent in 2004-05, but slightly edged up to ***77.63 per cent in 2011-12.*** The weights of mining sector had gone up over the years from 7.47 per cent in 1956 to 14.16 per cent in 2004-05 and further to 14.37 per cent in 2011-12. In sharp contrast, electricity sector had accounted for 3.68 per cent of total weights in 1956 which went up to 10.32 per cent in 2004-05 but dropped to 7.99 per cent in the 2011-12 series.

3. Building up of heavy and capital goods industries. As noted earlier, the Second Plan based on the Mahalanobis model gave pride of place to the development of heavy machine building industries and capital goods industries with a view to strengthening the industrial base of the economy. Accordingly, heavy investments were made in the capital goods industries and this enabled the country to expand the production of a wide range of engineering goods, iron and steel, metals and metal based products, etc. The weights of the capital goods industries in IIP correspondingly increased from just 4.71 per cent in 1956 to 16.43 per cent in 1980-81 (the weight of capital goods industries in new IIP (base 2011-12 = 100) is 8.32 per cent).

4. Rapid growth of consumer durables. Due to the policy of liberalisation pursued with great vigour by the government in recent period, the output of consumer durable goods has expanded at a fast pace. During 1981-85, the rate of growth of this segment was 14.4 per cent per annum which rose further to 16.9 per cent per annum during 1985-90. After a brief set-back in 1991-92 and 1992-93, the consumer durables sector again registered significant increases. As is clear from Table 26.3, the rate of growth of consumer durables sector was the highest among all sectors in the Eighth, Ninth and Eleventh Plans (13.4 per cent per annum in Eighth Plan, 10.4 per cent per annum in Tenth Plan and 15.6 per cent per annum in Eleventh Plan). The fast growth of this sector is a direct result of the 'opening up' of the industrial economy and the easy financing facilities being extended by a number of finance companies for the purchase of consumer durables. The weight of consumer durables in IIP which was just 2.21 in 1956 rose to 5.12 in 1993-94, 8.46 in 2004-05 and further to as high as 12.84 in the new IIP with base 2011-12 = 100.

On account of the declining weight of capital goods industries and the rising weight of the consumer durables goods industries in IIP, Rajakumar opines that "the industrial structure is (now) biased in favour of fulfilling the needs arising from changing consumption patterns rather than focusing on producing capital goods."[20]

5. Basic goods industries. Between 1956 and 2004-05, the weights of basic goods industries had nearly doubled from 22.33 per cent to 45.68 per cent. As noted earlier, the practice of compiling index values for basic goods industries has been discontinued in the new IIP (base 2011-12) and the category of primary goods industries has been introduced with weights of 34.05 per cent. Since there has been reshuffling of products from one group to another, one cannot firmly say if 'basic goods industries' category has become less important or not.

6. Increasing importance of core industries. The relative importance of eight core industries, or what was called 'infrastructure industries', shows a rise in the new

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IIP with their weights having gone up from 37.90 per cent in 2004-05 to 40.27 per cent in 2011-12. Within core industries, the weights of refinery products have gone up phenomenally from 15.67 per cent in the 2004-05 series to 28.04 per cent in the 2011-12 series, with simultaneous reduction in the weight of electricity to a considerable extent and crude oil to some extent. Weights of all other industries have changed marginally between the 2004-05 series and the new 2011-12 series. According to the new IIP, ***refinery industry has become far more important core industry replacing the hitherto dominant ones such as electricity and steel industries.***

The combined weight of the core industries in the new IIP (base 2011-12) is 40.27 per cent. Separate weights of the different core industries in the combined weight of core industries (taken as 100) are as follows: coal 10.33 per cent, crude oil 8.98 per cent, natural gas 6.88 per cent, refinery products 28.04 per cent, fertilisers 2.63 per cent, steel 17.92 per cent, cement 5.37 per cent and electricity 19.85 per cent.

7. Emergence of public sector. There was no public sector worth the name in the pre-Independence period. The entire range of activities in the industrial sector was controlled by the private sector. The post-Independence period saw the emergence and massive expansion of public sector. The number of central public sector units at the commencement of the First Plan was only 5 with a total capital of only ₹ 29 crore. The number of operating central public sector enterprises shot upto 244 in 2015-16. Capital employed in these enterprises was as high as ₹ 19,38,795 crore. Public sector enterprises play a pivotal role in the production of fuels, basic metal industries, non-ferrous metal industries, fertilisers, communication equipment, etc. However, in the post-1991 period, there has been an increasing emphasis on liberalisation and privatisation and the government has explicitly expressed its desire to bring down its equity in all non-strategic public sector undertakings to 26 per cent or lower, and to close down public sector units that cannot be revived. For this purpose, the government is following a policy of disinvestment in public sector enterprises.

SOME PROBLEMS OF INDUSTRIAL DEVELOPMENT IN INDIA

1. Gaps between targets and achievements. Excepting the period of the 1980s when targets of overall growth in industrial sector were achieved, in the entire earlier period of planning, achievements were below the targets. It has been estimated that ***the average shortfall in industrial achievement was about 20 per cent in each plan period during the pre-liberalisation phase***. Commenting on the experience of industrial development in the pre-1991 period, Rakesh Mohan has observed, "The average industrial growth rate achieved over thirty-five to forty years has been about 6.2 per cent relative to the average of about 8.0 per cent projected. On an approximate basis, also accounting for higher associated growth in the primary and tertiary sectors, this would come to about 1.2 to 1.4 per cent lower annual growth in the per capita GNP on a cumulative basis over thirty-five to forty years. If at current prices, the per capita Indian income is around US $ 300, it would have been about US $ 500-550 had these consistent shortfalls in industrial and other growth not taken place."[21]

2. The missing middle sector. The Indian manufacturing sector is characterised by the persistence of 'dualism'. There is a strong concentration of employment in small enterprises (6-9 workers) and large enterprises (employing more than 500 workers), with a conspicuous ***'missing middle'***. This would be clear from the fact that in 1984-85, 40.3 per cent of workers were employed in small enterprises (6-9 workers) and 30.2 per cent in large enterprises (more than 500 workers). The pattern remained almost unchanged in the post-reform period despite liberalisation and the package of reforms introduced in the industrial sector. For example, 41.5 per cent workers were engaged in small enterprises (6-9 workers) and 23.2 per cent in large enterprises (more than 500 workers) in 2000-01.[22] According to Dipak Mazumdar and Sandip Sarkar, ***"the missing middle implies a weak process of graduation of small firms and the development of entrepreneurship.*** It is arguable that the dispersion of entrepreneurship as well as industrial technology over a wide spectrum of spatially and economically distributed regions is dependent on the mushrooming of medium scale enterprises, into which the small units are able to graduate." Not only this. According to Mazumdar and Sarkar, the limited role of medium sized enterprises in the overall industrial structure strengthens and promotes market segmentation. "The market for industrial products is split into low quality products catering to the need of low-income consumers, and supplied by small-scale local producers on the one hand, and the higher quality segments which the large establishments supply to a limited number of high-income consumers. ***The lack of integration of markets could be a bottleneck in the development of mass markets for manufactured consumer goods."***[23]

3. Underutilisation of capacity. A large number of industries suffer from substantial underutilisation of capacity. Because of the difficulties in defining "capacity" there are vast differences in estimates of underutilisation of capacity in Indian industries. The estimates vary from 20-30 per cent to 60-70 per cent. However, it can be safely assumed that the average level of utilisation in a number of industries

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in India fluctuates around 50 to 60 per cent. The causes of this state of affairs are multifarious and range from technical to raw material shortages, frequent power failures, governmental policies, labour disputes and demand factor etc.

4. Performance of public sector. We have noted earlier in this chapter the phenomenal growth of public sector in the planning period. However, the performance of public sector enterprises has raised many eyebrows. Undoubtedly, the performance of the public sector units cannot be judged by the yardstick of profits since their justification lies in fulfilling certain broader socio-economic objectives. But accumulation of large losses in the public sector units is indeed a serious matter and calls for immediate corrective action. The unremunerative pricing policies which these enterprises have been forced to follow have amounted to indirect subsidisation of the private sector. Thus, private profits have expanded at the cost of the public exchequer.

5. Infrastructural constraints. One of the major constraints in industrial development is poor quality and high cost of infrastructure particularly power and transport network. Supply of coal has mostly been less than demand and this has had an adverse impact on the power situation. Shortage of gas availability has also resulted in considerable generation loss over the years. As far as transport network is concerned, it suffers from severe capacity and quality constraints. India has currently no inter-State expressways linking the major economic centres. Poor riding quality and congestion result in truck and bus speeds on Indian highways that average 30-40 kilometres an hour, about half the expected average. India's high-density rail corridors also face severe capacity constraints compounded by poor maintenance.[24] All such infrastructural constraints not only adversely affect industrial growth but will also reduce the competitiveness of Indian industries in the new global economic environment that is fast emerging.

6. Growth of regional imbalances. Industrial development in India has remained concentrated in a few States while other States continue to lag far behind. For instance, the four industrially advanced States of the country — Maharashtra, Gujarat, Karnataka and Tamil Nadu — accounted for 44.1 per cent of the total factories, 45.9 per cent of invested capital and 49.1 per cent of the gross output of the industrial sector in India in 2016-17.[25] Since the processes of economic development are closely linked with the processes of industrial development, it would not be illogical to argue that the process of economic development has more or less bypassed a number of poor States.

Though substantial investments in public sector were made in the relatively backward States of Bihar, Odisha and Madhya Pradesh, the expected 'trickling-down effects' of development were in no way evident and large tracts of these States remained untouched by planning. Schemes for developing backward areas were no more successful. Capital subsidies, fiscal incentives and other measures initiated to develop industries in backward areas were directed towards developing the backward areas of developed States and the demands of backward States were glossed over. Effective steps to reverse this process are called for urgently.

7. Industrial sickness. A number of industries are plagued by 'sickness' which in some cases is due to bad and inefficient management. Also, as noted by the *Sixth Five Year Plan,* 1980-85, "the pattern of industrial development has not been sufficiently guided by cost considerations. In a regime of protection from international competition, industries have tended to get established at sub-optimal capacities, leading to a high cost industrial structure. Adequate attention has also not been given to improvements in technology and quality of products. Some of these factors have led to the emergence of sickness in certain industries particularly when market conditions tend to generate a measure of competition within the economy."[26]

8. Emerging challenges. As a founder member of the World Trade Organisation (WTO), India has withdrawn all quantitative restrictions on imports. This is bound to result in intense competition with imports in coming years forcing a number of industrial units to close down. The 'pressure of competition' will be particularly harsh on many small-scale units as they simply cannot withstand competition from resource rich and technologically advanced multinational companies. In fact, even our large private sector companies are just pygmies *vis-à-vis* MNCs and many of them also may find the going tough. As far as the basic goods and capital goods industries are concerned, they might receive a set-back as the end-use industries will now have full access to cheaper imports. Things will not be easy for the end-use industries as well as they will have to compete with foreign goods on both price and quality fronts.

The Twelfth Five Year Plan gives the example of how Indian capital goods industry is being decimated by the Chinese industry. ***In the case of machine tools, imports now account for about two-thirds of the domestic requirements and is increasing further. The import of power-generation equipment from China at a much lower cost is also making the domestic industry uncompetitive.*** According to the Plan, the major factors responsible for

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increasing Chinese competitiveness are: (*i*) artificially depreciated Chinese currency, (*ii*) tax advantages and subsidies given by the government, (*iii*) much lower interest rates, (*iv*) simpler labour laws and (*v*) better infrastructure leading to lower cost of power, transportation and cluster approach helping specialisation of labour and engineering skills. Things are further complicated by the absence of level playing field for Indian manufacturers as they have to bear the burden of various taxes (sales tax, entry tax, octroi, VAT, many local duties, customs duty etc.). As pointed out by the Plan, Chinese industrial policy has evidently done far better than India in building depth in China's industries.[27]

NOTES

1. Data on 'industry and minerals' considered in the Chapter do not include the data on 'village and small-scale industries' as this is the normal practice. The latter group of industries are dealt with in a separate chapter.
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4. Government of India, Planning Commission, *Twelfth Five Year Plan* 2012-17 (Delhi, 2012), Volume I, Annexure 3.1, Table 3A.1, p. 99.
5. S.L. Shetty, "Structural Retrogression in the Indian Economy since the Mid-sixties", *Economic and Political Weekly*, Special Supplement, 1978, p. 8.
6. For the analysis of the causes of industrial retrogression the reader may refer to (*i*) Deepak Nayyar, "Industrial Development in India: Some Reflection on Growth and Stagnation", *Economic and Political Weekly*, Special Number 1978; (*ii*) Ashutosh Varshney, "Political Economy of Slow Industrial Growth in India", *Economic and Political Weekly*, September 1, 1984; (*iii*) Isher Judge Ahluwalia, *Industrial Growth in India — Stagnation since the Mid-sixties* (Delhi: Oxford University Press, 1985); (*iv*) C. Rangarajan, "Industrial Growth: Another Look", *Economic and Political Weekly*, Annual Number 1982; and (*v*) R. Ramana, "Performance of Capital Goods Sector in India 1955-79", *Economic and Political Weekly*, Annual Number 1984.
7. Vijay L. Kelkar and Rajiv Kumar, "Industrial Growth in the Eighties", *Economic and Political Weekly*, January 27, 1990, p. 211.
8. Isher Judge Ahluwalia, *Productivity and Growth in Indian Manufacturing* (Delhi: Oxford University Press, 1991), p. 211.
9. *Ibid.*, p. 92.
10. Sanjaya Baru, "Fiscal Liberalism and Industrial Growth", *The Economic Times*, September, 22, 1990.
11. R. Tharmarajakshi, "Intersectoral Terms of Trade Revisited", *Economic and Political Weekly*, March 31, 1990, Table 3, p. A-50.
12. Dalip S. Swamy, *The Political Economy of Industrialisation* (New Delhi, 1994), pp. 174-5.
13. Government of India, *Ninth Five Year Plan* 1997-2002 (New Delhi, 1999), Volume II, p. 589.
14. *Ibid.*, p. 590.
15. S.L. Shetty, "Reviving the Economy: Some Explorations", *Economic and Political Weekly*, July 28, 2001, p. 2825.
16. Government of India, *Economic Survey* 2011-12 (Delhi, 2012), Table 9.3, p. 205.
17. Government of India, *Economic Survey* 2013-14 (Delhi, 2014), p. 162.
18. Discussion in this section is based on J. Dennis Rajakumar, "Comparing IIP and NAS in Their New Incarnations", *Economic and Political Weekly*, September 30, 2017, pp. 77-8.
19. Discussion in this section is based on J. Dennis Rajakumar, *Ibid.*, pp. 79-80.
20. *Ibid.*, p. 79.
21. Rakesh Mohan, "Industrial Policy and Controls", in Bimal Jalan (ed.), *The Indian Economy: Problems and Prospects* (New Delhi, 1992), p. 107.
22. Dipak Mazumdar and Sandip Sarkar, "The Employment Problem in India and the Phenomenon of the Missing Middle", *Draft Paper for the Canadian Economic Conference*, Vancouver, June 6-8, 2008, Table 5, p. 12.
23. *Ibid.*, p. 14.
24. World Bank, *India: Sustaining Reforms, Reducing Poverty* (New Delhi, 2003), p. 69.
25. Reserve Bank of India, *Handbook of Statistics on Indian States* 2016-17 (Mumbai, 2017), Tables 76, 81 and 86.
26. Government of India, Planning Commission, *Sixth Five Year Plan* 1980-85, p. 260.
27. *Twelfth Five Year Plan*, *op. cit.*, Volume II, p. 67 and Box 13.2, p. 68.

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29 Chapter

INDUSTRIAL POLICY

After Independence, the Government of India spelt out its approach to the development of the industrial sector in the Industrial Policy Resolution 1948. This was followed by the Industrial Policy Resolution, 1956. In between, the government introduced the Industries (Development and Regulation) Act, 1951 to regulate and control the development of the private sector. In 1969, MRTP Act (Monopolies and Restrictive Trade Practices Act) was adopted to prevent concentration of economic power and control monopolies. Another legislation that had considerable implications for industrial policy (as far as the participation of foreign companies in industrial sector of India is concerned) was the Foreign Exchange Regulation Act (FERA) adopted in 1973. However, all these measures which guided and determined the State intervention in the field of industrial development failed in achieving the objectives laid down for them. They also created a number of inefficiencies, distortions and rigidities in the system. Therefore, the government started liberalising the industrial policy in 1970s and 1980s. The most drastic liberalisation was carried out in 1991 when a New Industrial Policy was announced.

We shall discuss the MRTP Act in Chapter 32 on 'Private Sector in the Indian Economy' and the FERA in Chapter 40 on 'Multinational Corporations, FERA and FEMA.' Other constituents of industrial policy are discussed in this chapter. The focus of discussion in this chapter, therefore, is on:

- Industrial Policy Resolutions of 1948 and 1956
- Industries (Development and Regulation) Act, 1951
- Critical review of pre-1991 industrial policy and liberalisation trends
- New Industrial Policy, 1991 and its critical appraisal
- National Manufacturing Policy, 2011
- Make in India
- Startup India.

INDUSTRIAL POLICY PRIOR TO 1991

Industrial Policy Resolution, 1948

The first important industrial policy statement was made in the Industrial Policy Resolution, 1948 issued by the Government of India on April 6, 1948. The Resolution accepted the importance of both private and public sectors in the industrial economy of India. It divided the industries into the following ***four*** categories:

1. Industries where State had a monopoly. In this category, *three* fields of activity were specified — arms and ammunition, atomic energy and rail transport.

2. Mixed sector. In this category, the following 6 industries were specified — coal, iron and steel, aircraft manufacture, shipbuilding, manufacture of telephone, telegraph and wireless apparatus (excluding radio sets) and mineral oils. New undertakings in this category were to be set up by the State but existing private undertakings were allowed to continue for 10 years after which the government was to review the situation and acquire any existing undertaking after paying compensation on a fair and equitable basis.

3. The field of government control. 18 industries of national importance were included in this category. The government did not undertake the responsibility of developing these industries but considered them of such importance that their regulation and direction was necessary. Some of the industries included were — automobiles, heavy chemicals, heavy machinery, machine tools, fertilisers, electrical engineering, sugar, paper, cement, cotton and woollen textiles.

4. The field of private enterprise. All other industries (not included in the above three categories) were left open to the private sector. However, the State could take over any industry in this sector also if its progress was unsatisfactory.

The 1948 Resolution also accepted the importance of small and cottage industries as they are particularly suited for the utilisation of local resources and for creation of employment opportunities.

Industrial Policy Resolution, 1956

The 1956 Resolution laid down the following objectives for the industrial policy: (*i*) to accelerate the rate of growth and to speed up industrialisation; (*ii*) to develop heavy industries and machine making industries; (*iii*) to expand public sector; (*iv*) to reduce disparities in income and wealth; (*v*) to build up a large and growing cooperative sector; and (*vi*) to prevent monopolies and the concentration

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of wealth and income in the hands of a small number of individuals.

These objectives, it was thought, would help in generating more employment opportunities and in raising the standard of living of the masses. For this purpose, stress was laid on cooperation between public and private sectors but an increasing role was envisaged for the former so that, in due course of time, it could gain 'commanding heights' of the economy.

The 1956 Resolution divided the industries into the following ***three*** categories:

1. Monopoly of the State. In this category, 17 industries were included whose future development was to be the exclusive responsibility of the State. These were listed in Schedule A appended to the Resolution. Of the 17 industries, 4 industries — arms and ammunition, atomic energy, railway and air transport — were to be government monopolies. In the remaining 13 industries, new units were to be established by the State but existing private units were allowed to subsist and expand. New units in the private sector could also be allowed 'when the national interest so required.'

2. Mixed sector of public and private enterprise. In this section, 12 industries listed in Schedule B (appended to the Resolution) were included. These were: all other minerals (except minor minerals), road transport, sea transport, machine tools, ferroalloys and tool steels, basic and intermediate products required by chemical industries such as manufacture of drugs, dyestuffs and plastics, antibiotics and other essential drugs, fertilisers, synthetic rubber, chemical pulp, carbonisation of coal, and aluminium and other non-ferrous metals not included in the first category. In these industries, State would increasingly establish new units and increase its participation but would not deny the private sector opportunities to set up units or expand existing units.

3. Industries left for private sector. All industries not listed in schedules 'A' or 'B' were included in the third category. These industries were left open to the private sector. Their development was to depend on the initiative and enterprise of the private sector, though even here the State could start any industry in which it was interested.

The 1956 Resolution emphasised the mutual dependence of public and private sectors. The only 4 industries in which private sector was not allowed to function were arms and ammunition, atomic energy, railways and air transport. In all other industries, either the private sector was allowed to operate freely or its help could be obtained if the government deemed fit. However, the private sector was to remain subject to various government regulations and controls as specified in Industries (Development and Regulation) Act, 1951 and other related regulations.

The 1956 Resolution recognised the importance of small-scale and cottage industries just as the 1948 Resolution had done. It also called for the reduction in regional imbalances and inequalities. For this purpose, it advocated that transport facilities, power and other facilities should be provided in backward regions.

As compared to the 1948 Resolution, the 1956 Resolution considerably enlarged the area of operation of the public sector as the exclusive responsibility of the State was enlarged from 6 to 17 industries (Schedule A). In addition, another category including 12 industries (Schedule B) was defined where the State could participate on an increasing scale. However, the 1956 Resolution dropped the 'threat' of nationalisation that the 1948 Resolution contained and the division of industries in different categories was more flexible in the former as compared to the latter. The fact is that the basic objective of both the Resolutions was the same — strengthening the mixed economy structure of the country.

Industries (Development and Regulation) Act, 1951

To control and regulate the process of industrial development in the country, an Act was passed by the Parliament in October 1951. Known as the Industries (Development and Regulation) Act, 1951, the Act came into force on May 8, 1952. The objectives that the Act sought to accomplish were: (*i*) the regulation of industrial investment and production according to plan priorities and targets; (*ii*) protection of small entrepreneurs against competition from large industries; (*iii*) prevention of monopoly and concentration of ownership of industries; and (*iv*) balanced regional development with a view to reducing disparities in the levels of development of different regions of the economy.

1. Restrictive Provisions. Under this category come all measures designed to curb unfair practices adopted by industries. These provisions were as follows: (*i*) ***Registration and licensing of industrial undertakings*** — Undertakings of all those industries which were included in the schedule of the Industries (Development and Regulation) Act, 1951, were required to be registered whether they come under the private sector or the public sector. Even if the existing undertakings intended expanding their activities, they required prior permission of the government; (*ii*) ***Enquiry of industries listed in the schedule*** — The responsibility of the State did not end with the registration or granting of licences to the undertakings. If the working of a particular industrial unit was not satisfactory (say, for example, there was substantial underutilisation of capacity or product was

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not up to the mark or cost of production and price were excessive), the government could set up an enquiry into the affairs of the particular undertaking; and (*iii*) ***Cancellation of registration and licence*** — If a particular industrial undertaking had succeeded in obtaining industrial licence and registration by submitting wrong information, the government could cancel the registration under article 10(A) of the Act. In the same way, the government could cancel the licence if the undertaking was not set up within the stipulated period.

2. Reformative Provisions. In this category, following provisions were considered: (*i*) ***Direct regulation or control by the government*** — If the government felt that a particular industry was not being run satisfactorily, it could issue directions for carrying out reforms. If these directions were not heeded to, the government could take over the management and control of that unit in its hands; (*ii*) ***Control on price, distribution, supply, etc.*** — The government was empowered in the Act to regulate or control the supply, distribution and price of the product manufactured by units belonging to the industries listed in the schedule of the Act, if it so wished; and (*iii*) ***Constructive measures*** — To inspire mutual confidence and elicit cooperation from the workers, the government established Central Advisory Council and a number of Development Councils for different products.

In the initial stages, 37 industries (specified under the Act) were brought under the purview of the Act which was later extended to include 70 industries. Of these specified industries, only those units were brought under the Act where the capital employed was ₹ 1 lakh or more. The exemption limit was subsequently increased in stages to ₹ 1 crore in 1970 and to ₹ 3 crore in 1978 and further to ₹ 5 crore later on. The government announced a major package of industrial delicensing during the year 1988-89. This package provided that henceforth, only projects involving an investment in fixed assets of more than ₹ 50 crore, if they are located in backward areas, or more than ₹ 15 crore if they are located in non-backward areas would require industrial licences.

REVIEW OF PRE-1991 INDUSTRIAL POLICY AND LIBERALISATION TRENDS

The actual operation of the industrial policy (particularly the industrial licensing policy) has been a subject of much debate and criticism. Several studies on the implementation of the licensing policies and the functioning of the industrial approval system pointed out a number of flaws and deficiencies. Reports of the various Committees and Commissions appointed by the government itself (Monopolies Enquiry Commission in April 1964, Dr. R.K. Hazari in 1965 and Dutt Committee in 1967) pointed out that the licensing policy had failed to achieve its objectives. In many cases, the results were just the opposite of what the government had planned. The main points of criticism have been as follows:

1. Licensing and underutilisation of capacity. Licensing was supposed to ensure creation of capacities according to plan priorities and targets. However, no clear priorities for private sector were laid down in plans and therefore the private sector chose those industries which appeared more profitable. In many cases, these industries happened to be luxury industries and frequently they also satisfied the technical curiosity of the DGTD (Directorate General of Technical Development) and were, therefore, granted licenses in defiance of the needs of essential industries producing commodities for mass consumption.

The grant of a licence to an enterprise was no guarantee that the production capacity permitted would actually be installed. The government had the right to take away a licence only several years later. Because of this fact, capacity created, in some cases, was less than allowed. Many industries (especially those belonging to the large monopoly houses) indulged in such practices to restrict output and raise prices. Since the government had no guarantee that the licensed capacity would actually be installed within the stipulated time, it adopted the practice of granting licences for capacities far in excess of the plan targets, from the end of the Second Plan. In those cases where actual implementation was larger than expected (as, for example, in the case of paper industry, cement industry and ceramic production) a sizeable unutilised capacity appeared. In some cases, overlicensing of an industry deterred the licencees from implementing their full licensed capacities for fear of excessive capacity creation in the industry. As a consequence of this, industries overlicensed in the Third Plan were marked by underfulfillment of capacity.

2. Licensing and concentration of economic power. As noted by Aurobindo Ghosh, in India: "It is industrial licensing which limits the areas of private investment and also determines entry into specific industries. The total volume of licensable private investment is normally (though not always) fixed in relation to the total Plan target of private investment in industry. This generally holds true of licensing in particular industries also, *i.e.*, in correspondence with Plan targets of capacity in specific industries. In such a situation, oligopolistic rivalry proceeds principally through competition for investment opportunities at the stage of entry into the industry itself".[1] This explains the behaviour of the large industrial houses in India who sought ***"pre-emption of investment opportunities" through acquiring as much industrial licences as possible thereby ensuring***

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an increasing share of new capacities created on the one hand, and on the other hand keeping out potential rivals.

3. Discretionary powers of licensing authorities. Martinussen has pointed out that ***because of the considerable discretionary powers vested in the regulatory agencies, the whole system tended to promote corruption, rent-seeking and discrimination based on personalistic relationships.***[2] In this context, Martinussen emphasises two features of the formal bureaucratic institutions functioning in India: *First*, "although separated from the rest of society by effective socialisation processes and specific rules which govern their behaviour, government officials often remain loyal to outside social networks. They are inclined in general to favour members of their own social network."[3] *Second*, "the individual government official at higher levels of the hierarchy is vested with considerable discretionary powers in his discharging of administrative functions. This has increased the scope for outside influence and for discrimination based on personalistic relationships."[4]

Because of the loyalty to outside social networks and personalistic relationships, a strong nexus between high government officials and managers of large industrial houses emerged in this country. As a result, the actual functioning of the industrial approval system in India favoured large industrial houses.

4. Licensing and regional imbalances. One of the avowed objectives of industrial licensing policy was the reduction in regional inequalities and imbalances. However, ***the actual operation of this policy*** has accomplished just the opposite — it ***tended to increase regional inequalities.*** As noted by the Dutt Committee, the four industrially advanced States of Maharashtra, Gujarat, West Bengal and Tamil Nadu benefited the most from the operation of this policy. For example, in the decade 1955-65, these four industrially advanced States accounted for 59.3 per cent of the applications and 62.42 per cent of the licences approved. On the other hand, the poor States of Bihar, Orissa, Uttar Pradesh and Madhya Pradesh received only 15.5 per cent of total licences approved. These trends continued in later years also. For instance, during the thirteen year period 1979 to 1992, the four industrially advanced States of Maharashtra, Gujarat, Tamil Nadu and West Bengal received 46.4 per cent of total licences issued whereas the combined share of Bihar, Orissa, Madhya Pradesh and Uttar Pradesh was only 16.2 per cent.[5]

5. Delays in processing of applications. Two developments added significantly to the burden on both the regulatory authorities and the private entrepreneurs. On the one hand, the coverage and degree of detail of the regulations was increased significantly (for instance, an amendment to the IDR Act in 1953 made it compulsory for companies to obtain a licence for the production of any 'new article' while in 1956 industrial activity and products were defined in much greater detail, thus adding to the number of permissions required), while on the other hand, industrial growth and diversification increased the scarcity of resources allocated administratively. The outcome was increasing delays in the processing of applications.[6] Moreover, the Licensing Committee worked in a very haphazard and ad hoc manner and there were no definite criteria adopted for acceptance or rejection of applications. This lack of explicit economic criteria was accompanied by the generally poor quality of techno-economic examinations conducted by the Directorate General of Technical Development (DGTD) which also took an unnecessarily long time for disposing of cases and submitting its recommendations to the Licensing Committee. All these factors impeded industrial growth.

The Liberalisation Trends

Because of the above criticisms indicating the failure of the industrial licensing policy in achieving its objectives, the Government of India announced a number of liberalisation measures in the Industrial Licensing Policy announced in 1970, 1973 and 1978. In 1980, the government came forward with an Industrial Policy Statement which served as a guideline to various liberalisation measures undertaken all through the 1980s. Some of these measures were as follows:

1. Exemption from Licensing. The limit of exemption from licensing was continuously raised upwards. In March 1978, the limit was fixed at ₹ 3 crore. During 1980s, it was first raised to ₹ 5 crore in 1983 and then to a whopping ₹ 15 crore for projects located in non-backward areas and ₹ 50 crore for projects located in backward areas in 1988-89 (under certain conditions).

2. Relaxations to MRTP and FERA Companies. Under the pretext of expanding industrial production and promoting exports, various concessions were provided to companies falling under the MRTP Act (Monopolies and Restrictive Trade Practices Act) and FERA (Foreign Exchange Regulation Act). The most important relaxation related to the raising of the limit for MRTP companies from ₹ 20 crore to ₹ 100 crore (*i.e.*, by five times) at one stroke in March 1985. In May 1983, the government notified that MRTP companies are eligible to set up, without the approval of the government, new capacities in industries of high national importance or industries with import substitution potential or those using sophisticated technology. On December 24, 1985, the government permitted the unrestricted entry of large industrial houses and companies governed by FERA into 21 high-technology items of manufacture. With this permission, the large industrial houses falling within the purview of the MRTP Act and FERA

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companies were allowed to freely take up the manufacture of 83 items. The government specified a list of 33 broad groups of industries under Appendix I in which MRTP and FERA companies were permitted to set up capacities, provided the concerned items are not reserved for the small-scale or public sectors. Various other concessions like regularisation of excess capacity and capacity re-endorsement, facilities to set up industries in backward areas etc. were also granted to MRTP and FERA companies.[7]

3. Delicensing. With a view to encouraging production, the government delicensed 28 broad categories of industries and 82 bulk drugs and their formulations. For these industries, only registration with the Secretariat for Industrial Approvals was now required: no licence had to be obtained under the Industries (Development and Regulation) Act. This was subject to the conditions that the undertakings concerned do not fall within the purview of the Monopolies and Restrictive Trade Practices (MRTP) Act or the Foreign Exchange Regulation Act (FERA), that the article of manufacture was not reserved for the small-scale sector and that the undertaking concerned was not located within specified urban locales. During 1989-90, some more industries were delicensed.

4. Re-endorsement of Capacity. With a view to improving capacity utilisation in industries, the government announced a scheme of capacity re-endorsement in April, 1982. During 1986, this scheme was liberalised to allow undertakings which had achieved 80 per cent capacity utilisation (as against 94 per cent earlier) to avail of the facility. The re-endorsed capacity was to be calculated by taking the highest production achieved during any of the previous five years plus one-third thereof. The undertakings which were able to achieve capacity utilisation equal to the re-endorsed level were to get further re-endorsement according to the highest production achieved in subsequent years. The number of industries for which automatic re-endorsement of capacity was not available was reduced from 77 to 26. With a view to encourage modernisation, renovation, replacement, etc., the government announced in 1986 exemption from licensing requirements of increases up to 49 per cent over licensed capacity.

5. Broad-banding of Industries. The scheme of broad banding of industries was introduced in 1984. This implied classification under broad categories — of two-wheelers, four-wheelers, tractors, as well as machinery for fertilisers, pharmaceuticals, and paper and pulp etc., into generic categories. Thus, to take one example, cars, jeeps, light, medium and heavy commercial vehicles, etc., were clubbed together into the generic category of "four-wheelers". This measure was intended to enable the manufacturers to change their product-mix rapidly to match changes in demand patterns without incurring procedural delays and other costs associated with seeking amendments to their industrial licences. Broad-banding was extended in stages to cover 45 broad industry groups.

6. Minimum Economies of Scales of Operation. Another important concept introduced in the field of industrial licensing was that of minimum economic level of operation. This was introduced in 1986. The idea was to encourage realisation of economies of scale by expansion of existing installed capacities of undertakings to minimum economic levels of operation. With this end in view, minimum economic capacities (MECs) were specified for 108 industries till 1989. Expansion of existing installed capacities was encouraged upto these MECs if they fell short of the latter. During 1989-90, MECs were specified for some more industries.

7. Development of Backward Areas. For promoting the development of backward areas, the government extended the scheme of delicensing in March 1986 to MRTP/FERA companies in respect of 20 industries in Appendix I for location in centrally declared backward areas. The scheme was later extended to 49 industries for location in any centrally declared backward area and to 23 non-Appendix-I industries for location in category 'A' backward districts. The conditions permitting MRTP and FERA companies to establish non-Appendix I industries in backward districts were also liberalised.

8. Incentives for Export Production. Various concessions were announced by the government in its industrial policy and export-import policy from time to time to promote the expansion of exports. As mentioned earlier, MRTP and FERA companies were permitted (outside the Appendix I industries) if the product was predominantly for export. With a view to providing fillip to production in industries of high national priority and/or those meant exclusively for export, the government introduced Section 22-A in the MRTP Act whereby it could notify industries or services to which Sections 21 and 22 of the Act would not apply. In October 1982, all 100 per cent export-oriented industries set up in the Free Trade Zones were exempted from Sections 21 and 22 of the Act. In addition, the government identified some industries which were specially important from export angle. These industries were allowed 5 per cent automatic growth per annum, upto a limit of 25 per cent in a plan period over and above the normal permissible limit for 25 per cent excess production over the authorised capacity.

9. Enhancement of Investment Limit for SSI Units and Ancillary Units. As stated earlier, the July 1980 Statement fixed the investment limit for small-scale industries at ₹ 20 lakh and for ancillary units at ₹ 25 lakh. In March

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1985, these limits were enhanced to ₹ 35 lakh and ₹ 45 lakh respectively. For tiny units, the investment limit stood at ₹ 2 lakh. These investment limits were raised subsequently. The MSMED Act, 2006, has fixed the investment limit for small-scale units to ₹ 5 crore for manufacturing enterprises and ₹ 2 crore for service enterprises.

NEW INDUSTRIAL POLICY, 1991

In line with the liberalisation measures announced during the 1980s, the government announced a New Industrial Policy on July 24, 1991. This new policy deregulates the industrial economy in a substantial manner. The major objectives of the new policy are "to build on the gains already made, correct the distortions or weaknesses that might have crept in, maintain a sustained growth in productivity and gainful employment, and attain international competitiveness." In pursuit of these objectives, the government announced a series of initiatives in respect of the policies relating to the following areas:

A. Industrial Licensing
B. Public Sector Policy
C. MRTP Act
D. Foreign Investment and Technology

A package for the Small and Tiny Sectors of industry was announced separately in August 1991 (already discussed in detail in Chapter 28).

Abolition of Industrial Licensing

Industrial licensing policy in India was governed by the Industries (Development and Regulation) Act, 1951. As we have discussed above, industrial licensing policy and procedures were liberalised considerably from time to time. Yet, the industrial licensing policy continued to be resented severely all along by the entrepreneurs as it led to unnecessary governmental and bureaucratic interference, delays in investment decisions, red-tapism, corruption, etc. Not only this, the industrial licensing policy was also unable to achieve the objectives laid down for it by the government. On account of these considerations, and in order to liberalise the economy and to enable the entrepreneurs to make investment decisions on the basis of their own commercial judgement, the 1991 industrial policy abolished industrial licensing for all but 18 industries. The 18 industries for which licensing was kept necessary were as under — coal and lignite; petroleum (other than crude) and its distillation products; distillation and brewing of alcoholic drinks; sugar; animal fats and oils; cigars and cigarettes; asbestos and asbestos-based products; plywood and other wood-based products; raw hides and skins and leather; tanned or dressed furskins; motor cars; paper and newsprint; electronic aeroscape and defence equipment; industrial explosives; hazardous chemicals; drugs and pharmaceuticals; entertainment electronics; and white goods (domestic refrigerators, washing machines, air-conditioners, etc.). With the passage of time, most of these industries have also been delicensed. ***As of now, licensing is compulsory for only 5 industries. These are alcohol, cigarettes, specified hazardous chemicals, electronics aeroscape and defence equipment, and industrial explosives.*** In respect of delicensed industry, no approval is required from the government.

Following the announcement of the New Industrial Policy, the DGTD (Directorate General of Technical Development) was abolished. According to Rakesh Mohan, "this must rank as one of the most important and consequential administrative decisions to be taken at the time" as it was the linchpin of the whole industrial 'command-and-control' system.[8]

Public Sector's Role Diluted

The 1956 Resolution had reserved 17 industries for the public sector. The 1991 industrial policy reduced this number to 8: (1) arms and ammunition, (2) atomic energy, (3) coal and lignite, (4) mineral oils, (5) mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond, (6) mining of copper, lead, zinc, tin, molybdenum and wolfarm, (7) minerals specified in the schedule to the atomic energy (control of production and use order), 1953, and (8) rail transport. In 1993, items 5 and 6 were deleted from the reserved list. In 1998-99, items 3 and 4 were also taken out from the reserved list. On May 9, 2001, the government opened up arms and ammunition sector also to the private sector. During 2014, private investment in rail infrastructure was allowed. ***At present only 2 industrial sectors are reserved for public sector. They are: (1) atomic energy, and (2) railway operations*** (excluding construction, operation and maintenance of certain works/projects like suburban corridor projects through PPP, high speed train project, dedicated freight lines, mass rapid transport systems, etc.).[9]

The new industrial policy also states that the government will undertake review of the existing public enterprises in low technology, small-scale and non-strategic areas as also when there is low or nil social consideration or public purpose. Sick units will be referred to the Board for Industrial and Financial Reconstruction (or a similar body) for advice about rehabilitation and reconstruction. For enterprises remaining in the public sector, it is stated that they will be provided a much greater degree of management autonomy through the system of MOU (memorandum of understanding).

The government has also announced its intention to offer a part of government shareholding in the public sector

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enterprises to mutual funds, financial institutions, the general public and the workers. A beginning in this direction was made in 1991-92 itself by divesting part of the equities of selected public sector enterprises. Over the period 1991-92 to end-March 2017, the government raised ₹ 2,47,383 crore through this means. Receipts from disinvestment in the financial year 2017-18 amounted to ₹ 1,00,057 crore. The new industrial policy indicates the government's intention to invite a greater degree of participation by the private sector in important areas of the economy.

MRTP Limit Goes

Under the MRTP Act, all firms with assets above a certain size (₹ 100 crore since 1985) were classified as MRTP firms. Such firms were permitted to enter selected industries only and this also on a case-by-case approval basis. In addition to control through industrial licensing, separate approvals were required by such large firms for any investment proposals. The government felt that this was having a deleterious effect on many large firms in their plans for growth and diversification. ***The new industrial policy therefore scrapped the threshold limit of assets in respect of MRTP and dominant undertakings.*** These firms are now at par with others, and do not require prior approval from the government for investment in the delicensed industries. The MRTP Act has accordingly been amended. The amended Act gives more emphasis to the prevention and control of monopolistic, restrictive and unfair trade practices so that consumers are adequately protected from such practices.

Freer Entry to Foreign Investment and Technology

As in the case of domestic industrial investment, foreign investment has also been traditionally regulated in India. In the case of both foreign technology agreements sought by Indian firms as well as foreign investment, it was necessary to obtain specific prior approval from the government for each project. It was argued that this caused undue delays and government interference and also hampered business decision-making. Therefore, the new industrial policy prepared a specified list of high technology and high-investment priority industries (listed in Annexure III) wherein automatic permission[10] was to be made available for direct foreign investment upto 51 per cent foreign equity. The industries in which automatic approval was granted included a wide range of industrial activities in the capital goods and metallurgical industries, entertainment electronics, food processing, and the services sectors having significant export potential. Besides, these included a number of other industries which are important for the rapid growth of the economy. The limit was subsequently raised from 51 per cent to 74 per cent and then to 100 per cent for many of these industries. Presently FDI (Foreign Direct Investment) is permitted for most activities and a small negative list has been notified where either the automatic route is not available or there are limits on FDI. For details regarding steps taken to promote foreign investment and technology in the period since 1991 please refer to the chapter on 'Foreign Capital and Aid.'

Other Liberalisation Measures

1. Industrial location policy liberalised. In a departure from the earlier locational policy for industries, the new industrial policy provided that in locations other than cities of more than 1 million population, there will be no requirement of obtaining industrial approvals from the Centre, except for industries subject to compulsory licensing. In cities with a population of more than 1 million, industries other than those of a non-polluting nature, were required to be located outside 25 kms of the periphery.

Major amendment in the industrial location policy was effected during 1997-98. The requirement of obtaining industrial approvals from the Central government (except for the industries under compulsory licensing) for establishing units at locations not falling within 25 kms of the periphery of cities having a population of more than 1 million was dispensed with. However, notified industries of a non-polluting nature such as electronics, computer software and printing, may be located within 25 kms of the periphery of cities with more than 1 million population. Other industries are permitted only if they are located in designated industrial areas set up prior to July 25, 1991. Zoning and Land-use Regulations as well as Environment Legislation continue to regulate industrial locations.

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

3. Removal of mandatory convertibility clause. A large part of industrial investment in India is financed by loans from banks and financial institutions. These institutions have followed a mandatory practice of including a convertibility clause in their lending operations for new projects. This has provided them an option of converting

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part of their loans into equity if felt necessary by their management. Although this option has not generally been exercised, it has often been interpreted as an unwarranted threat to private firms of takeover by financial institutions. The new industrial policy has provided that henceforth financial institutions will not impose this mandatory convertibility clause.

APPRAISAL OF NEW INDUSTRIAL POLICY

According to J.C. Sandesara, the new industrial policy seeks to raise efficiency and accelerate industrial production in five different ways:[11]

1. A number of changes in industrial licensing policy, foreign investment, foreign technology agreements and MRTP Act are such as to do away with the prior clearance of the government. In such cases, project time and, therefore, project cost will be reduced. Material and human resources engaged in cultivating contacts and 'getting things done' will be released for more productive uses. Thus, efficiency will improve.

2. The changes in respect of foreign investment and foreign technology agreements are also designed to attract capital, technology and managerial expertise from abroad. This will raise the availability of such scarce resources in the country on the one hand, and will improve the level of efficiency of production on the other hand.

3. Some changes as regards public sector may enhance the 'allocative efficiency'. Opening up of the areas so far reserved for the public sector to the private sector implies an opening for the sector which has, by and large, given a better account of itself. Closure, liquidation or rehabilitation etc. of sick/weak public sector units will free resources for more productive use. Similarly, privatisation may make for improved efficiency of the public sector, through its being subjected to the stock market discipline.

4. Other measures in this area such as purposeful formulation and implementation of Memorandum of Understanding and its monitoring, professionalisation and greater autonomy may be expected to improve the performance of the enterprises that will remain in the public sector.

5. Greater emphasis in controlling and regulating monopolistic, restrictive and unfair trade practices and the strengthening of the powers of the MRTP Commission will curb anti-competitive behaviour of firms in the monopolistic, oligopolistic and ineffectively competitive markets and thus promote competition and efficiency.

However, the new industrial policy 1991 has invited scathing criticism from a number of quarters. The main points of criticism are as follows:

1. Erratic and fluctuating industrial growth. As noted above, the new industrial policy considerably reduced the interventionist barriers to the entry of domestic and foreign investors, resulting in what has been proclaimed as a much more competitive environment in the industrial sector. It was hoped that this 'much more competitive environment' would, in itself, induce higher growth rates in the industrial sector. However, as discussed in Chapter 26, this has not happened. In fact, the rate of growth in the industrial sector declined in the post-reform period (particularly during the latter half of 1990s). For instance, the rate of growth of industrial production was only 5.0 per cent per annum during the period of the Ninth Plan (1997-98 to 2001-02) whereas it was 7.8 per cent per annum in the pre-reform decade (1980-81 to 1991-92). During 1990s as a whole (1990-91 to 1999-2000), the rate of growth of industry was only 5.7 per cent per annum. What is more, the post-1991 period witnessed erratic and fluctuating industrial growth rates in different years leading to conditions of instability and uncertainty.

This suggests that ***"liberalisation per se has not been enough to ensure high rates of growth of investment and productive activity, and that other strategies may be necessary to encourage the 'animal spirits' of entrepreneurs."***[12]

2. Distortions in production structure. From the point of view of long-run industrial development, the most important group of industries is the group of capital goods industries. However, the rate of growth of this group of industries fell drastically from 9.4 per cent per annum during 1980s to only 4.7 per cent per annum over the Ninth Plan period. The rate of growth of capital goods industry turned negative in 2012-13, 2013-14 and 2015-16. This points to the distortions in production structure in the post-reform period.

3. Threat from foreign competition. In the early euphoria of liberalisation, the private sector industrialists welcomed the new industrial policy 1991 but they soon came to realise that opening up the Indian economy to foreign competition meant more and cheaper imports, more foreign investment, opportunities to the MNCs (multinational corporations) to raid and takeover their enterprises, and worse, their inability to meet the challenge from MNCs due to their weak economic strength *vis-à-vis* the MNCs. ***In the new liberalised scenario that has emerged in the post-1991 reform phase, the Indian businessmen are facing unequal competition from MNCs.*** The 'unequal competition' stems from a number of reasons discussed in detail in the

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section on 'Effects of Globalisation' of Chapter 42 on "Globalisation and its Impact on the Indian Economy." As stated therein, the Indian enterprises suffer from 'size disadvantages' as they are just minuscules in comparison with MNCs; they have for long operated in a protectionist environment which promoted inefficiencies in production; the cost of capital to Indian business is much higher than for MNCs; they are very weak financially in comparison with MNCs; high, multiple and cascading indirect taxes — especially at the local level, where they are not applicable to foreign imports — result in making Indian goods uncompetitive; etc.

4. Dangers of business colonalisation. ***The various measures to promote foreign investment contained in the new industrial policy and the various concessions to such investment announced in recent years have provided opportunities to MNCs to penetrate the Indian economy and gobble up Indian enterprises.*** Baldev Raj Nayar has pointed out three strategies adopted by the MNCs to penetrate the Indian economy through FDI (foreign direct investment).[13] One, some foreign investors have bought off existing local brands alongwith their branded products with the aim of replacing such products with their own internationally known products, eliminating in the process the possibility of competition from the local products. Two, some foreign investors initially opted for joint ventures with Indian partners to gain easy foothold in the domestic industry but, once having consolidated their position, reduced the Indian partner to a subordinate position or simply ousted him. Thus, many Indian businessmen feel that MNCs simply use them as a 'door-mat' for entry and spread risk only to be dumped later. Three, some foreign investors, even as they started out with local partners in a joint venture, then went on to set up parallel 100 per cent subsidiaries of their own in the same field, which were then favoured with greater sources and more modern technology, rendering the joint venture uncompetitive and useless. The aggression which MNCs have shown to devour domestic enterprise has raised the dangers of business colonalisation.

5. Misplaced faith in foreign investment. Various policy pronouncements of the government in recent years indicate that it expects foreign investment to help in technological upgradation of the industrial sector and push up export earnings. However, this faith in foreign investment is misplaced. As pointed out by H.K. Paranjape, ***none of the MNCs operating in this country has attempted to develop India as an important base for a significant part of its worldwide research and development work.*** Despite various tax concessions and incentives none of the multinationals tried to expand export markets. They undertook export activities only to the extent they were compelled to do so under export obligations, or when it was found necessary to do so in order to be able to earn foreign exchange for importing some of their essential requirements.

Coming to the import of foreign technology, Paranjape again expresses some reservations. According to him, in the whole eagerness to import foreign technology, ***little attention seems to have been paid to the possibility that production and managerial technologies found more suitable in other countries may not necessarily prove to be the best in our circumstances.*** As correctly pointed out by him, one of the very purposes of India's industrialisation is to ensure that our very large manpower resources are effectively utilised. This implies the adoption of labour-intensive and capital-saving technologies in whichever areas it is feasible to do so. This may imply major readjustments in technologies that have developed in the labour-scarce and capital-abundant rich countries. This will not be an easy task.[14]

6. Personalistic relationships and corrupt practices continue to prevail. As stated earlier, the 'licence permit raj' of the pre-1991 period provided ample scope for rent-seeking as the entire operations of the industrial licensing policy were governed by personalistic relationships. According to John Dengbol-Martinussen while delicensing and deregulation has undoubtedly discouraged rent-seeking and corruption at the Central government level, these practices have continued and may have even increased at the State government level. This is due to the reason that while the number of interaction points between government officials and entrepreneurs have declined at the Union level, they have generally increased at the State level providing ample scope for continued interaction on a personalistic basis.[15]

NATIONAL MANUFACTURING POLICY

India's recent economic growth has been due to a massive surge in the services sector with the manufacturing sector continuing to stagnate, contributing only 15-16 per cent of GDP. As against this, the manufacturing sector in China accounts for about 42 per cent of GDP. In fact, India's manufacturing sector is only about 13 per cent of that of China's. It is now being increasingly recognised that unless India's manufacturing sector picks up strongly, it will be difficult to sustain rapid economic growth on the one hand, and provide productive employment opportunities to the increasing labour force on the other hand. History of all developed countries, Asian Tigers (South Korea, Hong Kong, Singapore and Taiwan) and China shows that all of them have attained economic growth by focusing more on the manufacturing sector where output is more tangible and

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where most of the innovations are first generated. All these considerations have once again brought back industrial policy into focus in the form of the National Manufacturing Policy (NMP) released by the Government of India on November 4, 2011.

Objectives of NMP

The main objectives of NMP are as under:

1. Increase manufacturing sector growth to 12-14 per cent over the medium term.
2. Increase the share of manufacturing in GDP from the present level of about 16.0 per cent to 25 per cent by 2022.
3. Create 100 million additional jobs in the manufacturing sector by 2022.
4. Create appropriate skill sets among the rural migrant and urban poor for their easy absorption in manufacturing.
5. Increase domestic value addition and technological depth in manufacturing.
6. Enhance global competitiveness of Indian manufacturing.

The NMP noted that the contribution of the manufacturing sector at about 16.0 per cent of India's GDP is much below its potential and a cause of concern especially in the context of other Asian countries in similar stages of development. This also has its socio-economic manifestations and prevents India from fully leveraging the opportunities of globalisation. India is a young country with over 60 per cent of its population in the working age group. With over 220 million people estimated to join the workforce in the next decade, the manufacturing sector will have to create gainful employment opportunities for at least half this number.

Policy Interventions

With a view to accelerating the growth of the manufacturing sector, the manufacturing policy proposes to create an enabling environment suitable for the sector to flourish in India. The NMP envisages simplification of business regulations without diluting their intent. Recognising the importance of small and medium enterprises (SMEs) in the country's economy, the policy contains dedicated interventions for SMEs in addition to other interventions for manufacturing industry generally. These interventions relate primarily to technology upgradation; adoption of environment-friendly technology; and equity investments. Skill development, to make young people employable, has been given high priority in the policy through fiscal incentives for the private sector and government schemes. National Investment and Manufacturing Zones (NIMZs) are also provided for on-lands which are degraded and uncultivable. NIMZs are envisaged as integrated industrial townships with world-class physical and social infrastructure (see Box 29.1). According to *Economic Survey* 2011-12, "The NMP, which is the first such dedicated policy measure for the manufacturing sector in the country, is expected to change the manufacturing landscape of the Indian economy through increased capital formation; industrial infrastructure of global standards; technology upgradation; creation of innovation and vocational skill development infrastructure; and industry, worker, and environment-friendly regulations."[16]

Eight investment regions along the Delhi-Mumbai Industrial Corridor (DMIC) project nodes have been accorded in-principle approval as NIMZs. In addition, twelve NIMZs

Box 29.1

National Investment and Manufacturing Zones

The NMP provides for the development of NIMZs as integrated industrial townships with state-of-the-art infrastructure and land use on the basis of zoning; lean and energy-efficient technology; necessary social infrastructure; and skill development facilities to provide a productive environment to persons transiting from the primary sector to the secondary and tertiary sectors. Key features of the proposed NIMZs are as follows:

- The State government would be responsible for the selection of suitable land having an area of 5,000 hectares in size.
- At least 30 per cent of the total area proposed under NIMZs will be utilised for location of manufacturing units.
- A special purpose vehicle (SPV) will be constituted to discharge the affairs of the NIMZ.
- The State government would facilitate the provisioning of water, power connectivity, and other infrastructure and utilities linkages.
- The Central government will bear the cost of master planning and will improve/provide external physical infrastructure linkages to NIMZs including rail, road (national highways), airports, and telecommunications in a time-bound manner.
- The Central government will provide financial support in the form of viability gap funding (VGF) not exceeding 20 per cent of project costs.
- Soft loans from multilateral financial institutions will be explored and the developers of NIMZs will be allowed to raise external commercial borrowings (ECBs) for developing internal infrastructure of the NIMZs.

Source: Government of India, *Economic Survey*, 2011-12 (Delhi, 2012), Box 9.3, p. 216.

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outside the DMIC region have been granted in-principle approval.[17]

A Critical Evaluation of NMP[18]

While accepting that the NMP is a 'well-crafted document having its various sections or parts clearly delineated', Sunil Mani has criticised it on following counts:

1. The NMP aims to increase the share of the manufacturing sector in India's GDP from the present level of around 15-16 per cent to about 25 per cent by 2022 and, in that process, create 100 million jobs. Crucial to this will be increasing the ratio of domestic value added to the domestic value of output through an enhancement of technological depth in manufacturing. In other words, the policy aims at improving local value addition by ensuring that the industry has most of the components, spare parts and raw materials locally available. However, "no specific targets are fixed on value added and so the goal is expressed in vague terms which makes its monitoring impossible."

2. The policy document is flawed in its arithmetic of arriving at the target to achieve a 25.0 per cent share of the GDP. Achieving the target will require the manufacturing sector to grow by 1 percentage point or more every year over the next ten years over the 9.0 per cent growth achieved by the sector in 2009-10 (in fact, as stated earlier, the NMP envisages a growth rate of 12-14 per cent over the medium term). "Given the very high inter-year variability in the growth performance of the sector seen since 1991, this appears to be virtually impossible."

3. As far as NIMZs are concerned, Sunil Mani raises two important questions: (*i*) in the light of recent instances in West Bengal and Orissa, how will the State governments arrange for a land having an area of 5,000 hectares?; and (*ii*) although the NIMZs are supposed to be different from SEZs (special economic zones) in the sense that they may not provide their occupants with tax concessions, there are a number of tax incentives and these will also add to the tax foregone by the exchequer. If the establishment of the NIMZs increases the revenue foregone, it will be a serious matter of concern as liberalisation has already led to an enormous increase in the financial incentives to the private sector. Moreover, as rightly pointed out by Sunil Mani, it is not correct to assume that firms in a cluster are more innovative than the firms that are not a part of the cluster.

4. Since the NMP focuses on increasing efficiency through increased competition between manufacturing firms, it will naturally increase the possibility of not very efficient firms exiting from the industry. This is likely to result in job losses. To tackle this problem, NMP proposes a suitable compensation to be paid to the workers through the operation of two alternate funding schemes — the job loss policy and the sinking fund. Under the former, the firms that are operating within an NIMZ may insure their workers against loss of employment in the event of the firm closing down or reducing labour force — due to the activation of a redundancy scheme. The second scheme, known as the sinking fund, is to be funded by contributions as decided by the SPV. However, the compensation under the two schemes is equivalent to just about seven months of pay at the rate of average pay per month over the 10-year period which does not amount to much of a compensation.

5. As far as pronouncements on issues such as technology acquisition, skill upgradation, public procurement, trade policies etc. are concerned, NMP does not state anything new. It merely brings together separate issues under one umbrella head.

6. NMP has failed to identify a small set of manufacturing industries in which India has a competitive position or is likely to attain one in the near future. In this context, it may be pointed out that China's success is basically due to the reason that it carefully defined with due diligence, a small set of those manufacturing industries in which it could graduate to world-class positions.

MAKE IN INDIA

The Prime Minister launched the 'Make in India' global initiative on September 25, 2014 to invite both domestic and foreign investors to invest in India. The initiative is based on four pillars, which have been identified to give boost to entrepreneurship in India, not only in manufacturing but also other sectors. The four pillars are:

1. New Processes. 'Make in India' recognises 'ease of doing business' as the single most important factor to promote entrepreneurship. A number of initiatives have accordingly been taken to ease business environment.

2. New Infrastructure. Government intends to develop industrial corridors and smart cities, create world class infrastructure with state-of-the-art technology and high-speed communication. Innovation and research activities are supported through fast paced registration system and improved infrastructure for intellectual property rights (IPR) registration. The requirement of skills for industry are to be identified and accordingly development of workforce is to be taken up.

3. New Sectors. 'Make in India' has identified 25 sectors in manufacturing, infrastructure and service activities. Detailed information on these sectors, alongwith details of the FDI Policy, National Manufacturing Policy, Intellectual Property Rights and the proposed National Industrial Corridors including Delhi Mumbai Industrial

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Corridor (DMIC) is being provided through an interactive web-portal and professionally developed brochures. FDI has been opened up in Defence production, Insurance, Medical devices, Construction and Railway infrastructure in a big way.

4. New Mindset. In order to partner with industry in economic development of the country, Government shall act as a facilitator and not a regulator.

The Government of India has set up ***Invest India*** as the national investment promotion and facilitation agency. With the objective of promoting investment in the country, a full-fledged Investment Facilitation cell has been set up under the Make in India initiative, primarily to support all investment queries as well as to handhold and liaise with various agencies on behalf of potential investors. Invest India will act as the first reference point for guiding foreign investors on all aspects of regulatory and policy issues and to assist them in obtaining regulatory clearances.

The Department of Industrial Policy and Promotion (DIPP), in consultation with various Central ministries, State governments, industry leaders and other stakeholders, has formulated a strategy for increasing the contribution of the manufacturing sector to 25 per cent of the GDP by 2020.

As envisaged by the National Manufacturing Policy 2011, Make in India seeks to create 100 million additional jobs in manufacturing by 2022. The government is taking a number of steps to enhance the skills of workers/the unemployed in India in order to improve their employability. In order to tap the creative potential and boost entrepreneurship in India, the Start-up India, Stand-up India campaign has been announced. An innovation promotion platform called Atal Innovation Mission (AIM) and a techno-financial, incubation and facilitation programme called Self-Employment and Talent Utilization (SETU) are being implemented to encourage innovation and start-ups in India.

'Make in India' initiative also aims to identify selected domestic companies having leadership in innovation and new technology for turning them into global champions. The focus would be on promoting green and advanced manufacturing and helping these companies to be part of the global value chain.

For supporting the financial needs of the small and medium enterprise sector and promote start-ups and entrepreneurship, the government has taken various steps through Make in India. The India Aspiration Fund has also been set up under the Small Industries Development Bank of India (SIDBI) for venture capital financing of newly set-up or expanding units in the MSME sector. SIDBI Make in India Loan for Small Enterprises (SMILE) has been launched to offer quasi-equity and term-based short-term loans to Indian SMEs with less stringent rules and regulations and a special focus on 22 thrust sectors of Make in India. Further, a Micro Units Development Refinance Agency (MUDRA) Bank has been set up to provide development and refinance to commercial banks/NBFCs/cooperative banks for loans given to micro units. MUDRA Bank would follow a credit-plus approach by also providing financial literacy and addressing skill gaps, information gaps, etc.

STARTUP INDIA

The 'Startup India' initiative, aims at fostering entrepreneurship and promoting innovation by creating an ecosystem that is conducive to growth. The initiative strives for providing a long due impetus to the entrepreneurial set up in economic landscape of the country. An Action Plan of 19 action items spanning across areas such as simplification and handholding, funding support and incentives and industry-academia partnership and incubation have been announced.

Since the launch of the initiative, a number of forward looking strategic amendments to the existing policy ecology have been introduced, like:

Startup Hub. A Startup India Hub has been set up to address queries of various startups and assist them through their lifecycle. Additionally, a facility for interaction for entrepreneurs on Twitter known as 'Twitter Seva' has also been launched.

Rolling-out of Mobile App and Portal. The Startup India Portal and Mobile App have been made operational. The portal and app provide functionalities such as making application for obtaining real-time Startup recognition, verification of recognition certificate, information availability such as list of incubators, Securities and Exchange Board of India (SEBI) registered funds, notifications issued by various departments, etc.

Fast-tracking Patent Registration and Legal Support. A scheme for Startups IPR Protection (SIPP) for facilitating fast track filing of patents, trademarks and designs by Startups has been introduced. The scheme thus provides for expedited examination of patents filed. This will reduce the time taken in getting patents. The fee for filing of patents has also been reduced up to 80 per cent.

Relaxed Norms in Public Procurement for Startups. Provisions have been introduced in the procurement policy to relax norms pertaining to prior experience/turnover for micro and small enterprises.

Tax Incentives. Tax incentives for Startup companies for a period of three years have been introduced in the Finance Act 2016.

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Building Innovation Centres and Setting up of Seven Research Parks. Two Research Parks, 16 Technology Business Incubators (TBIs) and 10 Startup Centres have been approved and shall be made operational soon. 25-30 new Innovation Centres have been envisaged to be launched in the current financial year.

Promoting Startups in Biotechnology Sector. Scheme guidelines have been drawn by Department of Bio-Technology (DBT) to scale up existing 15 bio-incubators.

Launching of Innovation Focused Programme. Scheme guidelines for Innovation core and Ucchattar Avishkar Yojana (UAY) have been finalized by Ministry of Human Resource Development (MHRD). The guidelines for the National Initiative for Developing and Harnessing Innovations (NIDHI) have been formulated and notified.

NOTES

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3. *Ibid.*, p. 89.
4. *Ibid.*, p. 89.
5. Computed from Government of India, *Handbook of Industrial Statistics*, 1992, Table 77, pp. 194-5, and *Handbook of Industrial Statistics*, 1993, Table 100, pp. 192-3.
6. John Degnbol-Martinussen, *op. cit.*, pp. 88-9.
7. For a detailed discussion, refer to the chapter on "Private Sector in the Indian Economy" and the chapter on "Multinational Corporations, FERA and FEMA".
8. Rakesh Mohan, "The Road to the 1991 Industrial Policy Reforms and Beyond: A Personalised Narrative from the Trenches", in Rakesh Mohan (ed.), *India Transformed: 25 Years of Economic Reforms* (New Delhi, 2017), p. 29.
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15. John Degnbol-Martinussen, *op. cit.*, pp. 205-6.
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17. Government of India, *India 2016 – A Reference Annual*, *op. cit.*, pp. 513-4.
18. Discussion in this section is based on Sunil Mani's article "National Manufacturing Policy: Making India a Powerhouse?," *Economic and Political Weekly*, December 31, 2011, pp. 16-19. All quotations are also from this article.

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34 Chapter

LABOUR RELATIONS AND SOCIAL SECURITY

The industrial sector frequently faces disputes and struggles on account of the fact that the interests of the employers and the employees are often at variance. While the former are interested in reducing wages and increasing the hours of work, the latter are interested in increasing wages and bettering the conditions of work. Industrial disputes often lead to 'strikes' and 'lockouts'. ***Strikes are resorted to by the workers to safeguard their interests, while lockouts are resorted to by the capitalists to pressurise the workers and compel them to tow their lines. Accordingly, both of these activities form a part of industrial disputes*** and lead to struggles disturbing the peace and tranquility of the industrial sector. This affects industrial activity adversely leading to underfulfilment of targets laid down in the Plans. It is on account of this reason that all plan documents in India have emphasised the necessity of preserving industrial peace. The First Five Year Plan, while recognising the right of the workers to strike, emphasised that "the stress of the administration as well as the efforts of parties should, however, be on avoidance of disputes and on securing internal settlement."

In the present chapter, we propose to discuss industrial relations, social security and related issues. The discussion is carried out under the following headings:

- Magnitude and causes of industrial disputes in India
- Industrial relations policy of the Government of India
- Social security legislation in India and a critical review of social security measures in India

MAGNITUDE OF INDUSTRIAL DISPUTES

The progress of industrialisation has been accompanied by increases in industrial disputes in India. This is a natural outcome of the conditions prevailing in the country. In addition to the fact that the base of industrial structure has considerably broadened and diversified over the years (opening new fields of industrial activity and thus, by implication, increasing the scope and area of industrial conflicts and confrontations), steep price increases and rising costs of living have compelled the workers to resort to strikes to maintain their real wages at least at constant levels.

The total number of work stoppages in 1951 was 1,071 involving 6.91 lakh workers and resulting in a total loss of 38.2 lakh man-days. The number of work stoppages, workers involved and total man-days lost increased considerably over the planning period. The number of work stoppages rose to the high figure of 2,938 in 1974 with the number of workers involved in the strikes rising to 28.55 lakh and the number of man-days lost to 402.6 lakh. The imposition of the Emergency in 1975 and suppressive measures that followed it, resulted in a steep decline in industrial disputes. However, restoration of normal conditions released the 'pent up' unrest among the workers and the years 1977 and 1978 saw a substantial increase in industrial disputes. In January 1982, the textile workers of Mumbai went on a prolonged general strike which resulted in a substantial loss of man-days. During 1989-90, the total man-days lost due to strikes and lockouts was 30.77 million. This fell to 23.60 million man-days in 1990-91 but rose to 34.57 million man-days in 1991-92. While the number of incidences of strikes and lockouts reported during 2010 were 371, these figures stood at 104 (Provisional) upto September 2015, and exhibited a declining trend over the period. Similarly, the figures for mandays lost were 23.13 million in 2010 and 1.66 million (Provisional) upto September 2015. As regards the spatial/industry wise dispersion of the incidences of strikes and lockouts, there exist widespread variation among different States/Union Territories. Wages and allowances, bonus, personnel, retrenchment, indiscipline and violence have been the major reasons for industrial strikes and lockouts in India.[1]

CAUSES OF INDUSTRIAL DISPUTES

As noted in the beginning of this chapter, industrial disputes are natural in the industrial sector since the interests of the employers and the workers are diametrically opposite. While the former aim at maximisation of profits, the latter aim at maximisation of wages and salaries. Disputes on the issues of wages and allowances, bonus, hours of work, leave, privileges, victimisation of employees, etc., are quite common in all countries. ***The two most important causes of industrial disputes in India have been the issue of***

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'wages and allowances' and 'personnel and retrenchment'. In fact, issue of 'wages and allowances' alone accounted for about 30 per cent of industrial disputes for a considerable period of planning. During 1991-2004, 'wages and allowances' accounted for 23.4 per cent of industrial disputes. Another 16.5 per cent of disputes were due to the issue of 'personnel and retrenchment'. This is a natural outcome of the situation that has prevailed in the country during the period of planning. In addition to the fact that wages of industrial workers are very low in this country, the rising price spiral has made it more and more difficult for them to keep their real wages at a constant level. Naturally the workers were forced to resort to strikes. However, despite all their struggle, the industrial workers did not succeed much in getting a rise in the level of their real income. For example, while the average per capita annual earnings of factory workers rose from ₹ 12,208 in 1991 to only ₹ 12,969 in 2003, the consumer price index number for industrial workers rose from 212 in 1991 (base 1982 = 100) to 496 in 2003 (*i.e.,* more than double the index number in 1991). This implies that ***the real wages of industrial workers actually declined in the post-reform period.***

In addition to 'wages and allowances' and 'personnel and retrenchment', another important cause of industrial disputes has been ***the issue of bonus***. The government has not been following a consistent policy on this issue also. It appointed the Bonus Commission in December 1961 under the chairmanship of M.R. Mehar to study the entire issue of bonus. Consequent upon the recommendations of this Commission, the government enacted the Payment of Bonus Act in 1965. This Act was to apply to all factories employing 20 or more workers and bonus was to be payable to an employee earning wages upto ₹ 1,600 per month. Bonus was fixed at 4 per cent of annual earnings or ₹ 40 whichever was higher. The Bonus Review Committee, 1972, with B.K. Madan as chairman extended the benefits of bonus to employees earning less than ₹ 2,000 per month and recommended minimum and maximum bonus of 8.33 per cent and 20 per cent respectively. Acting upon the Committee's recommendations, the government raised the minimum bonus from 4 per cent to 8.33 per cent. However, during emergency, the government scaled down minimum bonus to 4 per cent. The lifting of the emergency in 1977 brought the suppressed resentment of the workers into the open and there were large-scale strikes on the issue of bonus. As a result, the government had to raise the minimum bonus to 8.33 per cent. The eligibility for payment of bonus which stood at ₹ 10,000 a month earlier was raised to ₹ 21,000 a month by an amendment to the Payment of Bonus Act in December 2015. The calculation ceiling was also raised from ₹ 3,500 to ₹ 7,000 a month. This implies, if an employee is earning a salary of up to ₹ 7,000 per month, he or she is entitled to get a bonus on his or her entire salary or wage. However, if the salary is between ₹ 7,000 and ₹ 21,000 a month, the payable bonus will be calculated by considering the salary at ₹ 7,000 a month.

INDUSTRIAL RELATIONS: POLICY OF THE GOVERNMENT

India's industrial relations policy has had the following two basic objectives: (i) prevention and peaceful settlement of disputes, and (ii) promotion of good industrial relations via labour-management cooperation. Let us consider below some of the statutory and voluntary arrangements devised for the prevention and settlement of industrial disputes in India. We have already discussed the government policy on the issue of bonus. Below we discuss the various other measures adopted by the government from time to time.

The Legal Arrangement: Industrial Disputes Act 1947

A major step towards accomplishing the first objective was taken in 1947 itself with the passing of the Industrial Disputes Act, 1947. The object was to pre-empt industrial tensions, provide a mechanism for the settlement of disputes and set up the necessary infrastructure. ***The Act provides for the settlement of industrial disputes through conciliation, arbitration or adjudication***. It lays down the preconditions for the legality of strikes and lockouts. Provision is also made for payment of compensation for lay-off and retrenchment. The Act has been amended vide the Industrial Disputes (Amendment) Act, 2010 and enforced with effect from September 15, 2010.

Conciliation and Adjudication. The Act empowers the government to appoint conciliation officers for bringing about settlement of disputes through conciliation. If attempts at conciliation fail, the government can refer the disputes for adjudication if it so wishes. However, it is compulsory to refer a dispute for adjudication if the parties to the dispute jointly or separately apply for it or if the dispute relates to some public utility service and there is a notice of strike or lockout. 'Disputes' which have not occurred but are apprehended, can also be referred for adjudication. For purposes of adjudication, there is a three-tier system consisting of Labour Courts, Industrial Tribunals, and National Tribunals. The Labour Court deals with disputes on minor matters such as the propriety or legality of an employer's order regarding discharge or dismissal of workmen, etc. The Industrial Tribunal adjudicates on more important matters such as wages and allowances, hours of work, leave and holidays, etc. National Tribunals tackle questions of national

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importance and those that affect establishments situated in more than one State. The parties can, by agreement, refer a dispute for arbitration before it has been referred to a Labour Court or an Industrial Tribunal or a National Tribunal for adjudication.

Lay-off, Retrenchment and Closure. The special provisions relating to lay-off, retrenchment and closure are applicable to establishments employing 100 or more workmen on an average per working day. The Act also provides for protection in the shape of retrenchment compensation and notice to the workmen who have completed 240 days continuous service in the establishment in the preceding 12 months before effecting retrenchment, closure etc.

Settlement of Grievance. The amendment in 1982 introduced a new chapter providing for the setting up of Grievance Settlement Authority (GSA). The GSA is concerned with the settlement of all individual disputes in an establishment coming within its purview. An important feature of this machinery is that no reference to a Tribunal/Labour Court is to be made by the appropriate government till such time the dispute is heard by this authority and its decision becomes unacceptable to any of the parties to the dispute.

Unfair Labour Practice. Another chapter introduced by the amendment in 1982 related to unfair labour practices on the part of the employer and workman as well as penalty thereof. The chapter says that no employer or workman or a trade union whether registered under the Trade Union Act, 1926 or not is to commit any unfair practice. Any person who commits such a practice is punishable with imprisonment or with fine or both. The amendment empowered the Registrar to verify the membership of any union and to cancel the registration of any union which 'calls' or 'participates in' an illegal strike.

The Voluntary Arrangement: Code of Discipline and Industrial Truce Resolution

Code of Discipline. A Code of Discipline was adopted in 1958 by all the central organisations of employers and workers aimed at preventing and settling industrial disputes on a voluntary basis. The Code lays down that there should be no strike without notice; no unilateral action should be taken in connection with any industrial matter; no deliberate damage should be done to plant or machinery; acts of violence, intimidation, coercion or instigation should not be resorted to; there should be no recourse to go-slow tactics and normal work should not be disturbed; in case of disputes, the existing machinery should be utilised with the utmost expedition; the employers should recognise the majority union in the establishment and frame a grievance procedure; the management should take prompt action for the settlement of grievances and should implement the awards and agreements speedily, etc.

Industrial Truce Resolution, 1962. The Code of Discipline was strengthened by an Industrial Truce Resolution adopted in November 1962 by the central organisations of employers and workers. It laid down that there would be no interruption or slowing down of production; on the other hand, production will be maximised and defence effort promoted in all possible ways. A standing committee was set up in August 1963 to review the working of the Truce Resolution. This has since been merged with the Central Implementation Evaluation Committee.

Other Measures

Regulation of Wages. The payment of wages is governed by the Payment of Wages Act, 1936, and Minimum Wages Act, 1948, as amended from time to time. The Payment of Wages Act, 1936 was enacted with a view to ensure that wages payable to employed persons covered by the Act are disbursed by the employers within the prescribed time limit and that no deductions other than those authorised by law were made. The Act covered only those workers whose wages were below ₹ 1,600 per month. However, the wage ceiling has been raised subsequently in stages. With effect from September 11, 2012, the wage ceiling has been fixed at ₹ 18,000 per month.

The Minimum Wages Act, 1948 provides for fixation, review, revision and enforcement of minimum wages by the Central government and the State governments in respect of scheduled employments in their respective jurisdiction. There are 45 scheduled employments in the Central share whereas the number of these employments in the States' sphere is 1,596. To protect the wages against inflation, the government introduced Variable Dearness Allowance (VDA), which is linked to Consumer Price Index. The VDA is revised every six months. So far, 26 States/Union Territories have already adopted VDA as a part of minimum wage.

In the absence of a uniform national minimum wage, the concept of a national floor-level minimum wage (NFLMW) was mooted by the Central Government in 1996 based on the recommendations of the National Commission on Rural Labour in 1991 and subsequent increase in the price level. It was last revised to ₹ 160 per day with effect from 2015. At present NFLMW is a non-statutory measure.

Industrial Employment Standing Orders. Model rules were framed by the Government under the Industrial Employment (Standing Orders) Act, 1948, for adoption by the industrial establishments employing 100 or more workers to ensure industrial peace. Amendments to the Act were made in 1961 and 1963. The Central Government by notification on May 19, 1982, extended the Act to all industrial establishments under the control of the government for which it is the appropriate government and all mines, wherein 50 or more but less than 100 workers are employed.

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Equal Remuneration for Equal Work. The Equal Remuneration Act, 1976, provides for payment of equal remuneration to men and women workers for "the same work or a work of similar nature" and for the prevention of discrimination against women in matters of employment. The provisions of the Act have been extended to all employments.

Trade Unionism

The Trade Unions Act was passed in 1926. It provides for registration of trade unions of workers and in certain respects, it defines the law relating to registered trade unions. It confers legal and corporate status on registered trade unions. Prior to amendment in January 2002, the Act allowed any 7 or more members of a trade union to apply for registration of their union. After the amendment only such trade union can be registered which has at least 10 per cent or 100 (whichever is less) members. In no case, a union shall be registered without a minimum strength of 7 members. The 10 important central trade union organisations in India are: (*i*) Indian National Trade Union Congress (INTUC), (*ii*) All India Trade Union Congress (AITUC), (*iii*) Hind Mazdoor Sabha (HMS), (*iv*) United Trade Union Congress (UTUC), (*v*) Centre of Indian Trade Unions (CITU), (*vi*) Bharatiya Mazdoor Sangh (BMS), (*vii*) United Trade Union Congress (UTUC) (LS), (*viii*) National Front of Indian Trade Unions (NFITU), (*ix*) Hind Mazdoor Kisan Panchayat and (*x*) Indian Confederation of Labour.

SOCIAL SECURITY IN INDIA

Taken in its widest sense, social security means the 'security of the whole society'. This concept is so wide that it encompasses all activities of mankind in all spheres of human life. However, the term as commonly used connotes measures for economic security only under government auspices and such economic security in underdeveloped countries like India does not extend to all members of the society, but only to some restricted classes of people like industrial labour, government employees, etc. A coverage of the programmes under social security would be clear from the following definition put forward by Lord William Beveridge, "The term 'social security' is used to denote the security of an income to take the place of earnings when they are interrupted by unemployment, sickness or accident, to provide for retirement through age, to provide for loss of support by the death of another person, and to meet an exceptional expenditure, such as those connected with birth, death and marriage." ***Social security measures involve (1) providing cash payments to persons and families of a specified class whose income from earnings has been reduced drastically or ceased temporarily or permanently; (2) providing medical benefits and medical care to persons in the specified class in the event of sickness, maternity, etc.; and (3) providing cash payments in the form of stipends, pensions, etc. to the dependants of an employee in the event of his death.***

SOCIAL SECURITY LEGISLATIONS IN INDIA

Social security measures are usually divided into the following two categories: (i) social insurance and (ii) social assistance. Social insurance schemes are usually financed through contribution by the employees, employers and the State. The benefits to insured persons are linked to their contributions. Social assistance schemes seek to provide assistance to the poor and needy persons. They are not linked to the contributions made by the persons and are financed from the general revenues of the State.

The important social security legislations in India are briefly discussed below.

Employees' Compensation Act, 1923

A beginning in social security in India was made in 1923 when Workmen's Compensation Act was passed. The Act covers only workmen in factories and provides for the payment of compensation to them and their families in the case of industrial accidents and of certain occupational diseases arising out of and in the course of employment and resulting in death or disablement. The Act is very wide in coverage and covers many diverse industries including mines, factories, transport, plantations, construction activities, electricity generation etc., but certain specified categories (like members of the armed forces) are excluded. The government can include any class of persons employed in any other hazardous occupation. However, the Act does not apply to those industries or factories where Employees' State Insurance Act, 1948, is in operation. ***Prior to Amendment Act of 1984, the term "workman" covered only persons employed on wages not exceeding ₹ 1,000 p.m. However the WC (Amendment) Act, 1984, has done away with the salary restriction*** and thus any person who is employed in any capacity stipulated in Schedule II will be included in the definition irrespective of the wages drawn by him. Minimum rate of compensation for permanent disablement and death have been fixed at ₹ 1,40,000 and ₹ 1,20,000 respectively. Maximum amount for permanent total disablement and death can go upto ₹ 10.97 lakh and ₹ 9.14 lakh respectively depending on age and wages of workmen. After amendment in 2009, the Act was renamed as 'Employees' Compensation Act, 1923'.

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Maternity Benefit Act, 1961

The Maternity Benefit Act, 1961, regulates the employment of women in certain establishments for certain period before and after child birth (six weeks before and six weeks after confinement) and provides for maternity and other benefits. The Act also provides that no pregnant woman shall, on request being made by her, be required by her employer to do any arduous work one month before her expected delivery. The Act applies to mines, factories, circus, industry, plantations, shops and establishments employing 10 or more persons except the employees who are covered under the Employees' State Insurance Act, 1948. It can be extended to other establishments by the State governments. ***There is no wage limit for coverage under the Act.***

Employees' State Insurance Act, 1948

The most important step in the field of social security was taken in 1948 when the Employees' State Insurance (ESI) Act was passed. The Act is applicable to non-seasonal factories using power and employing 10 or more persons and non-power using factories employing 20 or more persons. The Act is being gradually extended by the State governments to new classes of establishments, namely, shops, hotels, restaurants, cinemas including preview theatres, road motor transport undertakings and newspapers establishments. ***The Act covers employees drawing wages not exceeding ₹15,000 per month*** with effect from May 1, 2010. Persons of armed forces are not covered in the ESI scheme.

Benefits under ESI. The ESIC has its own fund known as the ESI Fund. It is utilised for payment of cash benefits to the insured persons, provision for medical benefits under the scheme, establishment of hospitals, dispensaries, etc.

The ESI Act provides the following six major types of benefits to the insured persons — medical benefit, sickness benefit, disablement benefit, maternity benefit, dependants' benefit and the funeral benefit. As far as medical benefit is concerned, it involves free and complete medical care to all insured persons and their families. The person seeking such medical benefit gets free hospitalisation, free medical treatment and attendance, free consultation and dispension, etc. During indoor medical treatment, food is supplied free of cost.

The scheme of sickness benefit provides for periodical cash payments to an insured person in the event of his certified sickness. The benefit is payable for a maximum period of 91 days in any two consecutive benefit periods. However, in certain long drawn-out diseases, this period can be further extended. Maternity benefit is payable to an insured women employee for a period of 12 weeks (six weeks before and six weeks after the date of confinement). Disablement benefit is payable to an employee who suffers an injury resulting into disablement, whether permanent or temporary or who suffers from an occupational disease. The worker is paid for the period for which he is unable to work but if the period is less than three days, no benefit is paid. In the case of permanent disablement, the payment is made for lifetime and its rate is determined in proportion to the degree of disability as decided by the medical board. Dependants' benefit is paid to the dependants of the employee in the event of an employment injury resulting in the death of the employee. The dependants include the widow, minor children and parents of the deceased. Funeral benefit comprises the payment towards the expenditure on the funeral of the deceased insured person and is payable to the eldest surviving member of his family.

The ESIC Scheme has been extended to 101 new areas covering additional 1.28 lakh employees during 2015-16 and the number of beneficiaries covered under the Scheme has gone up to 7.89 crore.

Employees' Provident Fund and Miscellaneous Provisions Act, 1952

Retirement benefits in the form of provident fund, family pension and deposit linked insurance are available to the employees under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952. The object of this Act is to make: (1) some provisions for the future of the industrial worker after the retirement, (2) to provide for the dependants in the case of the employee's death, and (3) to cultivate the spirit of savings among the employees. ***The Act covers 186 industries/classes of establishments employing 20 or more persons.*** The rate of contribution is 12 per cent. Under the Act, employers are required to make a matching contribution.

Refund and Claims. Under the scheme, a subscriber can withdraw the full amount in the fund in the following cases: (*i*) retirement from active service after attaining the retirement age; (*ii*) retirement on account of permanent and total incapacity; (*iii*) migration from India for permanent settlement abroad; and (*iv*) termination of service in the course of mass retrenchment. Full amount of employer's contribution with interest is payable only when the subscriber has remained a member of the scheme for at least 15 years. If a subscriber remains member for less than 15 years, only a part of the accumulation of employer's share is payable to him. However, in all cases, he will always get back his own contribution to the Fund.

The scheme also provides for payment of non-refundable advances in certain contingencies like illness of family members, house building, purchasing shares of the Consumers Cooperative Credit Housing Societies, marriage of the member himself or of his dependant, damage to property due to some grave calamity, etc.

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Employees' Provident Fund Scheme, 1952

The Employees' Provident Fund Scheme 1952 seeks to provide financial security for employees in an establishment by providing a system of compulsory savings. The Scheme covers employees getting wages not exceeding ₹ 6,500 per month. A Death Relief Fund has been set up to provide immediate relief to the nominees/heirs of a deceased member under the Employees' Provident Fund Scheme.

Employees' Deposit Linked Insurance Scheme, 1976

The Employees' Deposit Linked Insurance Scheme was introduced for the members of the Employees' Provident Fund and the exempted Provident Funds with effect from August 1, 1976. A special feature of this scheme is that the members are not required to contribute to the Insurance Fund; only the employers and the government are required to make contributions. On the death of a member, the person entitled to receive the provident fund accumulations would be paid an additional amount equal to the average balance in the provident fund account of the deceased during the preceding twelve months. The maximum amount of benefit payable under the Scheme is ₹ 1,00,000 and the employees do not have to make any contribution to it.

The Payment of Gratuity Act, 1972

Gratuity is defined as a lumpsum payment made to a worker or to his heirs by the company on termination of his service due to retirement, retrenchment, invalidity or death. The Payment of Gratuity Act, 1972, is applicable to factories, mines, oil fields, plantations, ports, railways, motor transport undertakings, companies, shops and other establishments. ***The Act provides for payment of gratuity at the rate of 15 days wages for each completed year of service subject to a maximum of ₹ 10 lakh***. In the case of seasonal establishments, gratuity is payable at the rate of seven days' wage for each season. The Act does not affect the right of an employee to receive better terms of gratuity under any award or agreement or contract with the employer.

Employees' Pension Scheme, 1995

This scheme was introduced for the industrial workers with effect from November 16, 1995. Under the Scheme, pension at the rate of 50 per cent pay is payable to the employees on retirement/superannuation on completion of 33 years' contributory service. A minimum 10 years' service is required for entitlement to pension. Depending upon the salary and service of the employee at the time of death, the scheme also provides for grant of family pension ranging from ₹ 450 per month to ₹ 2,500 per month. In addition, children-pension at the rate of 25 per cent of widow pension subject to a minimum of ₹ 150 per child is also payable upto two children. The scheme is financed by diverting the employer's share of provident fund representing 8.33 per cent of the monthly wage to the pension fund. In addition, the Central government also contributes to the scheme at the rate of 1.16 per cent of the wage. The upper limit was raised from ₹ 5,000 to ₹ 6,500 with effect from June 1, 2001.

A CRITICAL REVIEW OF SOCIAL SECURITY MEASURES IN INDIA

As would be clear from the brief review of social security legislation in India, the government has undertaken various steps in the post-Independence period to provide social security to employees. However, we have only made a start so far and much needs to be done as would be clear from the following discussion.

1. Insufficient coverage. The most important criticism of the social security measures undertaken by the government is their totally insufficient coverage. A majority of the people continue to remain outside the ambit of social assistance and social insurance schemes. For example, the total employment in both organised and unorganised sectors in the country in 1999-2000 was of the order of 39.9 crore, *i.e.*, around 2.8 crore in the organised sector and the balance 37.1 crore (about 92.0 per cent) in the unorganised sector.[2] ***No social security scheme worth the name is available for the workers in the unorganised sector.***[3] Particularly miserable has been the condition of 23.9 crore workers employed in the unorganised sector in agricultural (of the total 37.1 crore workers employed in the unorganised sector) who have irregular employment and no land or property to fall back upon. Even in the organised sector, only persons working in establishments employing more than 20 persons are covered under most of the social security schemes.

In addition to workers employed in organised and unorganised sectors, ***there are a large number of 'unemployable people'*** — old and sick people, people suffering from various disabilities etc. No social security measures worth the name have been undertaken for this class of people. However, in recent times, the government has been trying to provide some semblance of social security to these people by introducing old age pension schemes and health insurance schemes (for example, the four public sector general insurance companies launched a Community-based 'Universal Health Insurance Scheme' in July 2003). For old persons an 'Integrated Programme for Older People' is being implemented which includes setting up of old age homes, day care centres and introducing mobile medicare units.

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2. No unemployment insurance. In many developed countries, there is provision for unemployment insurance. Benefits under such schemes are available to those individuals who are able to work and are available for work (as evidenced by registration at a public employment office). Such insurance enables the individual to meet his minimum subsistence requirement during the period he is seeking employment. However, because of the immense economic costs of this scheme, most of the underdeveloped countries (including India) have found it difficult to implement it. What we have in our country is a provision for retrenchment and lay-off compensation which does not even touch a fringe of the problem. Unless something is done to provide unemployment insurance, economic security cannot be achieved and in the absence of economic security, social security will also remain a dream.

3. Overlapping of schemes. India does not have an integrated scheme of social security. On account of this reason, there is considerable overlapping of schemes and similar benefits are being disbursed under various schemes. This results in wastage of effort and money. Though the idea of integrating the various schemes has been mooted at various seminars and discussions, nothing concrete has been done in this direction so far with the result that different schemes of practically the same nature continue to be administered by different agencies.

4. Inadequate facilities in relation to the needs of beneficiaries. The social security schemes are woefully inadequate in relation to the demand for them by the beneficiaries. For example, the medical and dispensing facilities available under the ESI schemes are very insufficient. The number of dispensaries and hospitals is much less than desired. Even the dispensaries and hospitals that exist are understaffed. The beneficiaries are put to a lot of trouble and botheration. There is overcrowding in the dispensaries and hospitals and their staff finds it difficult to cope with the demand on this service. Naturally, they get irritated and their behaviour towards patients is anything but cordial.

The critical review of the social security schemes in India suggests that there is a need to widen their coverage so that a majority of the people who continue to be outside their ambit are brought within it. There is also a need to bring about a qualitative improvement in the services provided, introduce unemployment insurance and bring about an integration amongst the various social security schemes.

NOTES

1. Government of India, *India 2017 – A Reference Annual* (New Delhi, 2017), p. 594.
2. S. Sakthivel and Pinaki Joddar, "Unorganised Sector Workforce in India", *Economic and Political Weekly*, May 27, 2006, Table 1, p. 2108 and Table 3, p. 2109.
3. The National Commission for Enterprises in the Unorganised Sector (NCEUS) submitted a report to the government on social security for unorganised workers on May 16, 2006. The scheme seeks to provide social security to 30 crore unorganised workers to be covered in a period of five years.

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36 Chapter

INDIA'S FOREIGN TRADE: VALUE, COMPOSITION AND DIRECTION

Most of the third world countries have a colonial past marked by extensive and intensive exploitation of their economies by the colonial powers. One of the important instruments of this exploitation has been the instrument of foreign trade. Raul Prebisch, Hans Singer, Gunnar Myrdal, Ragnar Nurkse and many other development economists in the 1940s and the 1950s pointed out that the colonial powers have had the best of both worlds, both as consumers of primary commodities and as producers of manufactured articles while the colonies (the underdeveloped countries) have had the worst of both worlds, as consumers of manufactures and producers of raw materials. This was due to declining prices of primary goods and increasing prices of manufactured goods causing the terms of trade to deteriorate considerably over time for the underdeveloped countries (which were exporters of primary goods). Therefore, many underdeveloped countries that won Independence in the post-World War II period viewed foreign trade and investment with a certain amount of suspicion. Accordingly, they turned their attention to the domestic markets. Many of them also adopted large-scale programmes of industrialisation to build up the industrial sectors of their economies and reduce their dependence for manufactured goods on the developed countries. Therefore ***the emphasis was on 'inward-oriented' policies. As far as foreign trade is concerned, this meant large-scale import substitution (through extensive protection of domestic industries), direct controls on imports and investments, and overvalued exchange rates.***[1] ***As far as export sector is concerned, it was marked by extreme pessimism.*** For instance, after Independence, the widely prevalent view in Indian government circles was that the Indian exports faced a stagnant world demand and nothing much could be done to increase them.[2]

However, things have now radically changed. Many developing countries adopted programmes of import liberalisation and export promotion in the 1960s and achieved remarkable successes. These included Japan, Singapore, Hong Kong, South Korea and Taiwan. The success of these countries has prompted many economists and international agencies (most prominent among them being the IMF and the World Bank) to advocate import liberalisation and export promotion as a panacea for many economic ills facing developing countries like India. Acting upon their advice, the Government of India has opted for a policy of trade liberalisation in recent years. Massive trade policy reforms were announced in 1991 to open up the economy to foreign trade and to 'integrate' the Indian economy into the global economy in the new international economic order that is taking shape with the setting up of the WTO (World Trade Organisation) in 1995. The trade policy reforms initiated by the Government of India are discussed in detail in the chapter on 'Trade Policy of the Government of India' while measures pertaining to foreign capital are discussed in the chapter on 'Foreign Capital and Aid.' The present chapter is devoted to a discussion of trends in the foreign trade of India. The discussion is divided into the following sections:

- Value of foreign trade in the planning period
- Composition of foreign trade
- Direction of foreign trade
- Growth and structure of India's foreign trade in the post-reform period.

VALUE OF EXPORTS AND IMPORTS IN THE PLANNING PERIOD

Table 36.1 presents information on the value of foreign trade in India over the period of planning in terms of US dollars. As is clear from this Table, the value of India's exports and imports has increased considerably over the period of planning. From $ 1,269 million in 1950-51, exports rose to $ 8,486 million in 1980-81 and further to $ 3,30,070 million in 2018-19. Imports during this period rose from $ 1,273 million in 1950-51 to $ 15,869 million in 1980-81 and further to $ 5,14,034 million in 2018-19. It can also be noted that the country has faced substantial trade deficits during the period of planning. In fact, ***a study of foreign trade data reveals that trade balance was positive in only two years during the entire period 1949-50 to 2018-19. These were the years of 1972-73 and 1976-77 when the country recorded small trade surpluses of $ 134 million and $ 77 million respectively. In all other years, deficits in balance of trade were recorded.*** What is a matter

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Table 36.1

Value of Exports and Imports in the Planning Period

(US $ million)

Year	*Exports*	*Imports*	*Trade Balance*	*Rate of Change*	
				Exports	*Imports*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1950-51	1269	1273	−4	24.9	−1.5
1960-61	1346	2353	−1007	0.3	16.7
1970-71	2031	2162	−131	8.8	3.5
1979-80	7947	11321	−3374	13.9	36.4
1980-81	8486	15869	−7383	6.8	40.2
1985-86	8904	16067	−7163	−9.9	11.5
1989-90	16612	21219	−4607	18.9	8.8
1990-91	18143	24075	−5932	9.2	13.5
1991-92	17865	19411	−1546	−1.5	−19.4
1992-93	18537	21882	−3345	3.8	12.7
1994-95	26330	28654	−2324	18.4	22.9
1995-96	31797	36678	−4881	20.8	28.0
2000-01	44076	49975	−5899	20.0	0.5
2004-05	83536	111517	−27981	30.8	42.7
2005-06	103091	149166	−46075	23.4	33.8
2006-07	126414	185735	−59321	22.6	24.5
2007-08	163132	251654	−88522	29.0	35.5
2008-09	185295	303696	−118401	13.6	20.7
2009-10	178751	288373	−109621	−3.5	−5.0
2010-11	251136	369769	−118633	40.5	28.2
2011-12	305964	489319	−183356	21.8	32.3
2012-13	300401	490737	−190336	−1.8	0.3
2013-14	314405	450200	−135794	4.7	−8.3
2014-15	310338	448033	−137695	−1.3	−0.5
2015-16	262291	381008	−118717	−15.5	−15.0
2016-17	275852	384357	−108505	5.2	0.9
2017-18	303526	465581	−162055	10.0	21.1
2018-19	329536	514034	−184498	8.8	10.4

Source: Government of India, *Economic Survey* 2017-18 (Delhi, 2018), Volume II, Statistical Appendix, Table 7.1(B), pp. A104-A105.

for concern is the fact that the trade deficit has increased significantly over the years. In fact, the average trade deficit in the Sixth Plan (1980-81 to 1984-85) works out at $ 5,985 million per annum and $ 5,669 million per annum during the Seventh Plan (1985-86 to 1989-90).

The year 1990-91 saw a trade deficit of $ 5,932 million as imports rose by 13.5 per cent against a rise of 9.2 per cent registered by exports over the year 1989-90. However, strict import restrictions were imposed in 1991-92 which led to a 19.4 per cent reduction in the value of imports and the trade deficit declined to $ 1,546 million. However, this sharp cut-back in imports had a decelerating effect on industrial growth and to reverse this trend, massive import liberalisation measures were undertaken in 1992-93. As a result, imports rose considerably and trade deficit touched $ 3,345 million in 1992-93. The next three years (1993-94 to 1995-96) saw a strong resurgence in export earnings. Although imports also increased yet the overall situation was better and the average trade deficit during the Eighth Plan period (1992-97) was $ 3,456 million per annum — considerably less than the trade deficit recorded in the Sixth and Seventh Plan periods. However, during the period of Ninth Five Year Plan (1997-2002), there was marked deterioration. The average trade deficit in this Plan was as high as $ 8,412 million. What is more, there were considerable year-to-year fluctuations in trade performance. Excepting the year 1999-2000 (when imports increased by 17.2 per cent basically due to a sharp rise of 97.1 per cent in imports of crude oil following hardening of international prices of crude) imports remained sluggish in the other years of the Ninth Plan due to slackening in domestic demand following industrial slowdown.

However, the period of the Tenth Plan was marked by considerable revival of foreign trade. The rate of growth of exports in this Plan was consistently above 20 per cent per annum with the rate of growth touching 30.8 per cent in 2004-05 (highest since 1975-76 and second highest since 1950-51). In 2006-07, the rate of growth of exports was 22.6 per cent. The value of exports more than doubled in this Plan from $ 52,719 million in 2002-03 to $ 1,26,414 million in 2006-07. Both external and domestic factors contributed to this satisfactory performance.

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Improved global growth and recovery in world trade aided the strengthening of Indian exports. As far as domestic factors are concerned, the opening up of the economy and corporate restructuring has enhanced the competitiveness of Indian industry. There is a far greater export-orientation of domestic manufacturers, and corporate sector has been pursuing new growth strategies in response to economic reforms. Merchandise imports also increased considerably during the Tenth Plan. The main reasons were high international prices of crude oil, lower import tariffs and a buoyant domestic economy (which resulted in higher imports of capital goods, industrial raw materials and intermediate goods). During the period of the Tenth Plan, imports increased by three times from $ 61,412 million in 2002-03 to $ 1,85,735 million in 2006-07. Because of substantial increase in imports, the trade deficit rose considerably. Trade deficit in 2006-07 was as high as $ 59.32 billion. The first year of the Eleventh Plan, 2007-08, saw a large trade deficit of $ 88.52 billion. The main reason for this was the substantial increase in oil import bill from $ 57.14 billion in 2006-07 to $ 79.64 billion in 2007-08 — a staggering 39.4 per cent rise in a single year. The year 2008-09 was the year of global recession. However, despite this, exports managed to increase at a reasonable rate of 13.6 per cent in this year. Yet the trade deficit in this year rose to $ 118.4 billion due to a faster increase of 20.8 per cent in imports. Trade deficit rose to $ 183.36 billion in 2011-12 and further to the ***record level of $ 190.34 billion in 2012-13 (which is the highest level recorded in the post-Independence period).*** The situation improved somewhat in 2013-14 and trade deficit declined to $ 135.8 billion. This was basically due to a modest recovery in exports and a sharp fall in imports, particularly gold imports. In 2014-15, the trade deficit was marginally higher at $ 137.7 billion. Trade deficit continued to be at a lower level due to decline in the value of POL (petroleum oil and lubricants) imports by 16.0 per cent, caused by a fall in international oil prices by 20.2 per cent.[3] As is clear from Table 36.1, both exports and imports fell significantly in 2015-16 (exports by 15.5 per cent and imports by 15.1 per cent). As far as exports are concerned, lower oil prices brought refined petroleum products to about half their level a year ago. Non-oil exports declined by 8.5 per cent, with exports of key products including engineering goods, electronics, leather and gems and jewellery contracting in terms of either volume or value or both. Imports declined basically because of a sharp reduction in oil import bill. Trade deficit in 2015-16 was $ 118.35 billion – lowest level since 2010-11.[4] After two years of negative growth, exports recorded a positive growth of 5.2 per cent in 2016-17. This was due to a substantial pick-up of exports in the second half of 2016-17 – the notable drivers being engineering goods, petroleum products, iron ore, cotton yarn, chemicals, marine products, gems and jewellery, and readymade garments.[5] As far as imports are concerned, they increased only marginally. The net result of these trends was that the trade deficit fell in this year – from $ 118.7 billion in 2015-16 to $ 108.5 billion in 2016-17. However, because of massive increase in import expenditure by as much as 21 per cent in 2017-18 as against as increase in export earning of 10.0 per cent, trade deficit rose to as high as $162 billion in 2017-18. This rose further to $ 184.5 billion in 2018-19.

COMPOSITION OF FOREIGN TRADE

By composition of foreign trade of any country, we imply the composition of exports and imports. An examination of the composition of foreign trade of a country enables us to analyse the progress of that country and the rate and speed of structural changes operating in it. For example, if we find on scrutiny that the country in question imports foodgrains and raw material but exports finished goods, machinery, and capital equipment, we can safely conclude that it has reached a high level of economic development. On the other hand, if it exports primary commodities like jute, tea, raw cotton, sugar, etc., but imports capital equipment and machinery, finished goods, etc., we can conclude that the country is an underdeveloped one. The speed with which such a country changes its pattern of trade (leading to a percentage decline in imports of manufactured products and percentage increase in the exports of such products) is sometimes taken by some economists as an indication of the pace of development in the country.

Before the advent of planning in India, main exports were primary goods like jute, tea, cotton, hides and skins, manganese ore, mica, etc., while manufactured products constituted the bulk of imports. During the planning period, the process of industrialisation and economic development has induced a number of changes in the composition of foreign trade, as would be clear from the discussion below.

Composition of Imports

In 1947-48, the main items of imports in India (in order of importance were: machinery of all kinds; oils (vegetable, mineral and animal); grains, pulses and flour; cotton, raw and waste; vehicles (excluding locomotives); cutlery, hardware, implements and instruments; chemicals, drugs and medicines; dyes and colours; other yarns and textile fabrics; paper, paper board and stationery; and metals other than iron and steel and manufactured. These imports together constituted more than 70 per cent of all imports.

The initiation of the planning process in the country in 1951-52, and more specifically the beginning of the Second Five Year in 1956-57 brought about a considerable change

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in the composition of imports. The Second Plan (based on the Mahalanobis Model) introduced a programme of industrialisation with heavy emphasis on the development of capital goods and basic industries. As a result, it became necessary to import capital equipment in large quantities. After some years, spare parts, materials and machinery had to be imported in substantial quantities to keep the equipment in working order. Thus, 'maintenance imports' entered into the import structure of the country in a big way. The composition of imports since 1960-61 is given in Table 36.2.

For convenience, imports of the country have been divided into four broad groups: (*i*) Food and live animals chiefly for food, (*ii*) Raw materials and intermediate manufactures, (*iii*) Capital goods and (*iv*) Other goods. The table shows that the total imports in 1960-61 were $ 2,353 million of which the share of the above groups was 19.1, 47.0, 31.7 and 2.2 per cent respectively. There have been significant changes in the relative importance of these groups over time. The most important change is that the imports of food and live animals have declined sharply. This is due to the decline in the imports of cereals and cereal preparations. For instance, from 16.1 per cent in 1960-61, the share of cereals and cereal preparations fell to almost zero per cent in 2018-19. On the other hand, the share of raw materials and intermediate manufactures has increased considerably primarily due to a sharp rise in the import of petroleum oil and lubricants, fertilisers and pearls and precious stones. Capital goods had accounted for about one-third of import expenditure in 1960-61 which fell to a little more than one-fifth in 1996-97. In 2018-19, the share of capital goods in total imports was 25.8 per cent (*i.e.,* one-fourth of total imports). Capital goods include (i) machinery, except electrical and machine goods (ii) electrical machinery, (iii) electronic goods, (iii) Import equipment, and (v) project goods

Important facts regarding the composition of different import items are as follows:

1. There has been a substantial rise in the import expenditure on POL (petroleum, oil and lubricants) imports. For example, POL imports accounted for only 6.1 per cent of import expenditure in 1960-61 and 8.3 per cent in 1970-71. This increased dramatically to 41.9 per cent in 1980-81. This sharp increase was due to two hikes in oil prices in 1970s — one in 1973-74 when the Oil and Petroleum Exporting Countries (OPEC) raised the price of oil from around $ 2.50 to $ 3.00 per barrel to $ 11.65 per barrel and the other in 1978-79 when the price of oil was raised sharply to $ 35.00 per barrel. The period of 1980s was marked by substantial increase in domestic oil production on the one hand and a softening of international oil prices on the other hand. As a result, the share of POL imports in total import expenditure declined considerably to 25 per cent in 1991-92. In percentage terms, the share of POL imports in total imports varied between 25.0 per cent to 30 per cent during 1990s. In 2014-15, imports of POL were $ 1,38,326 million which was 30.9 per cent of total import expenditure. However, because of a fall in international crude oil prices, imports of POL fell to $ 82,944 million in 2015-16 which was 21.8 per cent of total import expenditure. POL imports in 2018-19 was as high as 1,48,918 million which was 27.4 per cent of total imports.

2. Since 1999-2000, data on imports of gold and silver have become available as their imports are now channelised through the official routes. As a result, data on imports of 'non-ferrous metals' in Table 36.2 for the years 2017-18 and 2018-19 include the data on imports of gold and silver also. In 2018-19, imports of non-ferrous metals stood at $ 51,376 million which was 10.0 per cent of total import expenditure.

3. Imports of electronic goods have increased considerably in recent years. In 2018-19, electronic goods accounted for 11.2 per cent of total import expenditure.

4. Due to the increasing demand of the gems and jewellery industry (which has emerged as an important export earning industry) the imports of 'pearls, precious and semi-precious stones' have increased significantly. In fact, this item accounted for 11.3 per cent of import expenditure in 1993-94 and occupied the second place. Imports of 'pearls, precious and semi-precious stones' in 2018-19 stood at $ 27,076 million which was 5.3 per cent of total import expenditure.

5. Import expenditure on non-electrical and electrical machinery rose considerably from $ 434 million in 1970-71 to $ 37,853 million in 2018-19. In percentage terms, its share was 20.1 per cent in 1970-71 and 7.4 per cent in 2018-19.

6. Because of increasing domestic demand, edible oils also have had to be imported on a considerable scale in certain years. For example, in 1987-88, edible oils worth $ 969 million had to be imported. This was 4.4 per cent of total import expenditure in that year. In 2018-19, imports of edible oils were of $ 9,891 million which was 1.9 per cent of total import expenditure.

7. Despite increasing domestic production of iron and steel, substantial quantities continue to be imported as domestic production has failed to keep pace with the rising demand. While in absolute terms, the imports of iron and steel rose from $ 194 million in 1970-71 to $ 1,178 million in 1990-91, in percentage terms they have more or less consistently fallen (from 9.0 per cent in 1970-71 to 4.9 per cent in 1990-91). In 2018-19, their share in import expenditure was 2.4 per cent.

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Table 36.2

Composition of Imports

Commodities	1960-61		1970-71		1980-81		1990-91		2017-18		2018-19	
	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total
1. Food and live animals chiefly for food	**449**	**19.1**	**321**	**14.8**	**481**	**3.0**	**N.A.**	**N.A.**	**N.A.**	**4.9**	**N.A.**	**3.2**
of which:												
Cereal and cereal preparations	380	16.1	282	13.0	127	0.8	102	0.4	536	0.1	211	0.0
2. Raw materials and intermediate manufactures	**1105**	**47.0**	**1176**	**54.4**	**12341**	**77.8**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**
of which:												
(a) Edible oils	8	0.4	31	1.4	857	5.4	182	0.8	11637	2.5	9890	1.9
(b) Petroleum oil and lubricants	145	6.1	180	8.3	6656	41.9	6028	25.0	108659	23.3	140918	27.4
(c) Fertilisers	27	1.1	113	5.3	1034	6.5	984	4.1	5376	1.1	7467	1.3
(d) Iron and Steel	258	11.0	194	9.0	1078	6.8	1178	4.9	10437	2.3	12582	2.4
(e) Chemical elements and compounds	82	3.5	90	4.2	453	2.8	1276	5.3	27295	5.9	31535	6.1
(f) Pearls and precious stones	2	0.1	33	1.5	527	3.3	2083	8.7	34279	7.4	27076	5.3
(g) Non-ferrous metals*	99	4.2	158	7.3	604	3.8	614	2.5	49683	10.7	51379	10.0
3. Capital goods	**747**	**31.7**	**534**	**24.7**	**2416**	**15.2**	**58.33**	**24.2**	**1,16,230**	**25.0**	**1,28,626**	**25.0**
of which:												
(a) Manufacture of metal	48	9.0	12	0.6	113	0.7	160	0.7	5,435	1.2	6,065	1.2
(b) Machinery, electrical and non-electrical	546	23.2	434	20.1	1705	10.8	3312	13.7	33,908	7.1	37,853	7.4
(*b*) Electronic goods	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	53076	11.9	57,572	11.3
(c) Transport equipment	151	6.4	88	4.1	597	3.8	931	3.9	22739	4.9	24760	4.8
4. Others (unclassified)	**52**	**2.2**	**131**	**6.1**	**631**	**4.0**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**
Total	**2353**	**100.0**	**2162**	**100.0**	**15869**	**100.0**	**24075**	**100.0**	**465581**	**100.0**	**514034**	**100.0**

N.A.: Data 'not available'.

* Since 1999-2000 data on imports of gold and silver are available (because imports of gold and silver are now channelised through the official routes). Therefore, the data on 'non-ferrous metals' for the years 2015-16 and 2016-17 include the data on gold and silver also.

** Capital goods include (i) machinery, electrical and non-electrical (ii) electronic goods, (iii) transport equipment.

Source: (*i*) Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2016-17 (Mumbai, 2017), Table 130, p. 201; and (*ii*) Government of India, *Economic Survey* 2017-18 (Delhi, 2018), Volume II, Statistical Appendix, Table 7.2(A), pp. A103-A104, Table 7.2(B), p. A105.

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8. Import expenditure on fertilisers and fertiliser materials increased considerably from $ 113 million in 1970-71 to $ 1,683 million in 1995-96. This is due to the increasing requirement of fertilisers for the implementation of the new agricultural strategy and also due to the increasing prices of fertilisers in the international market. In percentage terms, the share of fertilisers in total imports has varied between 3.5 to 6 per cent over the period 1970-71 to 1995-96. In 2018-19, its share in total import expenditure stood at 1.5 per cent.

9. Foodgrains have had to be imported on a considerable scale for a number of years to meet the domestic requirements of the economy. Their share in imports stood at as much as 16 per cent in 1960-61. Despite green revolution and consequent increases in foodgrains production and productivity, imports of foodgrains constituted 13 per cent of total imports in 1970-71 and as much as 25.5 per cent in 1975-76 (*i.e.,* about one-fourth). In later years, due to substantial increase in foodgrains production at home, the imports fell steeply. In 2015-16, imports of foodgrains were merely $ 276 million (however, they rose to $ 1429 million in 2016-17 but fell to only $ 211 million in 2018-19.

10. In recent years, massive quantities of coal have had to be imported due to acute shortage of domestic coal. In fact, in a single year 2010-11 to 2011-12, imports of coal, coke and briquettes etc. rose from $ 9,804 million to as high as $ 17,444 million. These imports stood at $ 22,901 million in 2017-18. Which was 4.9 per cent of import expenditure in that year.

Composition of Exports

Composition of Indian exports is presented in Table 36.3. A clear trend over the years has been a decline in the importance of agriculture and allied products and a substantial increase in the importance of manufactured products. For instance, the share of agriculture and allied products in total exports declined considerably from 44.2 per cent in 1960-61 to 11.8 per cent in 2018-19, while that of manufactured products increased from 45.3 per cent to 70.3 per cent over the same period. This clearly depicts the changing production structure of the economy and the march from an underdeveloped, backward, primary goods dependent economy to a more vibrant industrial economy.

Important points that emerge from Table 36.3 regarding different export items are as follows:

1. The most important export item in 1960-61 was jute and it contributed 21 per cent (or a little more than *one-fifth*) of total export earnings. Since then its share has continuously declined (to 12.4 per cent in 1970-71 and 0.1 per cent in 2016-17).

2. The second most important export item in 1960-61 was tea and it contributed 19.3 per cent (*i.e.,* almost *one fifth*) of total export earnings. Its share has also declined consistently to 9.6 per cent in 1970-71 and 0.3 per cent in 2018-19. During recent years, it has contributed more earnings as compared to jute.

3. Consequent upon the programmes of industrialisation initiated during the planning period, the exports of engineering goods rose substantially. From $ 46 million in 1960-61, exports of engineering goods rose to $ 261 million in 1970-71 and further to $ 92,454 million in 2018-19. As a result, their share in India's export earnings rose from 3.4 per cent in 1960-61 to 28.7 per cent in 2018-19. ***Engineering goods occupied the first place in India's export earnings in 2018-19.***

4. During recent years, exports of petroleum products have increased significantly. Their exports were as high as $ 29,030 million in 2007-08 which was 17.8 per cent of total export earnings. In this year, petroleum products occupied the second position in India's export earnings after engineering goods. In fact, export growth in 2007-2008 was driven mainly by petroleum products with 53.6 per cent growth and engineering goods with 24.6 per cent growth. According to *Economic Survey,* 2007-08, "the perceptible increase in the share of petroleum products in total exports reflected not only the rise in POL prices but also India's enhanced refining capacity."[6] In 2018-19, exports of petroleum products were $ 47,874 million which was 14.5 per cent of total export earnings. Petroleum exports now occupy second place in India's export earnings after engineering goods.

5. The results of industrialisation are also expressed through increases in the exports of chemicals and allied products. From $ 39 million in 1970-71, the exports of chemicals and allied products rose to $ 46,001 million in 2016-17. In 2018-19, they contributed 11.9 per cent of total export earning.

6. As is clear from Table 36.3, exports of gems and jewellery have recorded a spectacular increase. From $59 million in 1970-71 (representing 2.9 per cent of total export earnings), the exports of gems and jewellery rose to $ 40,251 million in 2018-19 which was 12.2 per cent of total export earnings. In this year, gems and jewellery occupied third position in India's export earnings. Petroleum export non occupy second place in India's export after engineering good.

7. Export of readymade garments has emerged as an important foreign exchange earner in recent years. In 1970-71 export of readymade garments was only $ 2 million. In 2018-19 this had risen to $ 18,918 million (*i.e.,* 5.3 per cent) of total export earnings.

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Table 36.3

Composition of Exports

Commodities	1960-61		1970-71		1980-81		1990-91		2017-18		2018-19	
	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total	$ million	% of total
1. Agriculture and allied products	**596**	**44.2**	**644**	**31.7**	**2601**	**30.6**	**3521**	**19.4**	**38,654**	**12.7**	**38,829**	**11.8**
of which:												
(a) Tea and mate	260	19.3	196	9.6	538	6.3	596	3.4	837	0.3	831	0.3
(b) Cashew kernels	40	3.0	76	3.7	177	2.1	249	1.4	939	0.3	658	0.2
(c) Rice	—	—	7	0.3	283	3.3	257	1.4	7806	2.6	7753	2.3
(d) Fish and fish preparations	10	0.8	40	2.0	274	3.2	535	2.9	7389	2.4	6802	2.1
2. Ores and Minerals (excluding coal)	**109**	**8.1**	**217**	**10.7**	**523**	**6.2**	**834**	**4.6**	**5648**	**1.9**	**5928**	**1.8**
of which:												
Iron Ore	36	2.6	155	7.6	384	4.5	585	3.2	1478	0.1	1319	0.4
3. Manufactured goods	**610**	**45.3**	**1021**	**50.3**	**4738**	**55.8**	**13229**	**72.9**	**216122**	**71.2**	**231953**	**70.3**
of which:												
(a) Cotton yarn, fabrics, made-ups etc.	136	10.1	188	9.2	516	6.1	1170	6.4	8908	2.1	9843	3.0
(b) Readymade garments	2	0.1	39	1.9	696	8.2	2236	12.8	10706	5.5	18911	5.7
(c) Jute manufactures	283	21.0	252	12.4	417	4.9	166	0.9	335	0.1	325	0.0
(d) Leather and Leather manufactures	59	4.4	106	5.2	493	5.8	1449	8.0	5829	1.9	5140	1.6
(e) Gems and jewellery	2	0.1	59	2.9	782	9.2	2924	16.1	41544	13.7	40251	12.2
(f) Chemicals and allied products	15	1.1	39	1.9	284	3.3	1176	6.5	30800	10.1	37840	11.9
(g) Engineering goods	46	3.4	261	12.9	1045	12.3	2158	11.9	85089	28.0	92450	28.0
4. Petroleum Products*	**15**	**1.1**	**17**	**0.8**	**35**	**0.4**	**528**	**2.9**	**38431**	**12.7**	**47874**	**14.5**
5. Others	**16**	**1.3**	**132**	**6.5**	**589**	**7.0**	**3.6**	**0.2**	**2930**	**1.0**	**4612**	**1.4**
Total Exports	**1346**	**100.0**	**2031**	**100.0**	**8486**	**100.0**	**18143**	**100.0**	**303526**	**100.0**	**330070**	**100.0**

*For 1960-61, 1970-71 and 1980-81, the data are for 'mineral fuels and lubricants'.

Source: (*i*) Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Table 128, p. 199 and (*ii*) Government of India, *Economic Survey* 2018-19 (Delhi, 2019), Volume II, Statistical Appendix, Table 7.3(A), pp. A110-A112 and 7.3(B), p. A113.

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8. Export earnings from cotton yarn, fabrics, made-ups, etc., stood at $ 9,848 million in 2018-19 which was 3.6 per cent of total export earnings.

9. Export earnings from iron ore increased from $ 1,126 million in 2003-04 (which was 1.8 per cent of export earnings) to 4,629 million in 2011-12 (which was 1.5 per cent of total export earnings). However, their exports fell considerably to $ 1,651 million in 2012-13 on account of restrictions on mining on the one hand, and efforts to divert iron ore supplies to meet requirements of domestic iron and steel industry on the other hand. Exports of iron ore in 2015-16 were just $ 193 million but jumped to $ 1,534 million in 2016-17 due to rising demand from Chinese steel industry. Exports of iron ore in 2018-19 were just $ 1,318 million.

10. Exports of leather and leather manufactures was $ 3,361 million in 2009-10 and $ 5,140 million in 2018-19. Their share in export earnings stood at 1.6 per cent in 2018-19.

11. 'Fish and fish preparations' increased their share in export earnings from 2.0 per cent in 1970-71 to 4.3 per cent in 1994-95. In 1995-96, however, their share fell to 3.2 per cent. The exports of 'fish and fish preparations' stood at $ 6,802 million in 2018-19 which was 2.1 per cent of export earnings.

12. In recent years, substantial quantities of rice have been exported. For instance, export earnings from rice stood at $ 907 million in 1997-98, $ 1,493 million in 1998-99 and $ 721 million in 1999-2000. In 2018-19, exports of rice rose to $ 7,753 million which was 2.3 per cent of total export earnings.

DIRECTION OF TRADE

In the pre-Independence period, the direction of India's foreign trade was determined not according to the comparative cost advantages of India but by the colonial relations between India and Britain. In other words, it was Britain that decided from which countries India could import its requirements and to which countries it could export its products. Naturally, a major part of India's trade was either directly with Britain or its colonies or allies. This pattern continued for some years after Independence as well since India had not till then explored the possibilities of developing trade relations with other countries of the world. For example, the combined share of UK and USA in India's export earnings was 42 per cent in 1950-51. Their share in India's import expenditure was as much as 39.1 per cent in the same year. With other capitalist countries like France, Germany, Italy, Japan, etc. India either did not have trade relations at all or they were very insignificant. As political and diplomatic contacts developed with other countries, economic relations also made a headway. Thus, new vistas for developing trade relations with other countries opened up. The situation has changed very much since, and now after six decades of planning, the trading relations exhibit marked changes. The diversification in trade relations has reduced the vulnerability of the economy to outside political pressures.

Direction of Imports

For purposes of studying direction of trade, India's trading partners have been divided into five major groups in Table 36.4: OECD, OPEC, Eastern Europe, Developing Nations and Others. First consider imports. As is clear from the table, the importance of OECD as a group declined considerably over the period 1960-61 to 2017-18. The share of this group in India's import expenditure was 78 per cent in 1960-61 which fell to 37.2 per cent in 2017-18. The share of the group of oil exporting countries (OPEC) increased considerably over time. From 4.6 per cent in 1960-61, the share of this group in India's imports increased to 27.8 per cent in 1980-81 and stood at 23.5 per cent in 2017-18 (i.e., almost one-fourth). This is due to India's dependence on these countries for meeting its crude oil requirements. As trade relations expanded with socialist countries, the share of Eastern Europe in imports also increased considerably from 3.4 per cent in 1960-61 to 10.3 per cent in 1980-81 and stood at 7.8 per cent in 1990-91. Due to the setback to communist regimes in this block during the last two decades (and particularly, due to the disintegration of USSR), the share of Eastern Europe in imports declined considerably and was only 2.4 per cent in 2017-18. As is clear from the Table, developing nations (particularly of Asia) have increased their share considerably in India's imports. They accounted for 44.5 per cent of India's import expenditure in 2017-18. Important facts regarding India's country-wise imports are as under:

In the year 1950-51, the share of UK in India's imports was 20.8 per cent and that of USA was 18.3 per cent. Thus, the combined share of these two countries was 39.1 per cent. This reflected the colonial heritage of the country. Within a decade, the picture started showing some changes. New trading partners like West Germany, Canada and USSR emerged. There was a change in the relative position of UK and USA as well, with the latter pushing down the former to the ***second*** place. ***During the planning period as a whole, India has obtained maximum imports from USA, the reason being that India has imported large scale quantities of capital goods, intermediate products and foodgrains (under PL 480 agreement) from that***

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Table 36.4

Direction of India's Trade

Commodities		Imports						Exports					
		1960-61	*1970-71*	*1980-81*	*1990-91*	*2016-17*	*2017-18*	*1960-61*	*1970-71*	*1980-81*	*1990-91*	*2015-16*	*2016-17*	*2017-18*
I. OECD		**78.0**	**63.8**	**45.7**	**54.0**	**28.1**	**37.2**	**66.1**	**50.1**	**46.6**	**53.5**	**38.6**	**37.9**	**39.4**
of which:														
1. EU		37.1	19.6	21.0	29.4	10.8	10.7	18.4	21.6	27.5	21.8	17.1	17.2	17.7
(*a*) Belgium	5093.4	1.4	0.7	2.4	6.3	1.1	1.3	0.8	1.3	2.2	3.9	1.9	2.0	2.0
(*b*) Germany	13295.7	10.9	6.6	5.5	8.0	3.0	2.9	3.7	2.1	5.7	7.8	2.7	2.6	2.9
(*d*) UK	4807.2	19.4	7.8	5.8	6.7	1.0	1.0	26.8	11.1	5.9	6.5	3.4	3.1	3.2
2. USA	26611.1	29.2	27.7	12.9	12.1	5.7	5.7	16.0	13.5	11.1	14.7	15.4	15.3	15.8
3. Switzerland	108359.2	—	0.7	1.0	1.1	4.5	4.1	—	0.5	1.6	1.2	0.4	0.3	0.3
4. Japan	10973.5	5.4	5.1	6.0	7.5	2.2	2.3	3.4	13.3	8.9	9.3	1.8	1.4	1.0
II. OPEC		**4.6**	**7.7**	**27.8**	**16.3**	**24.1**	**23.5**	**4.1**	**6.4**	**11.1**	**5.6**	**17.6**	**16.4**	**14.6**
of which:														
1. UAE	2174.0	—	—	2.8	4.4	5.0	4.7	—	0.4	2.3	2.4	11.6	11.3	9.3
2. Iran	11111.5	—	—	—	0.3	2.7	8.4	—	—	—	0.6	1.1	0.9	0.9
3. Saudi Arabia	22070.0	1.3	1.5	4.3	6.7	5.2	4.9	0.9	2.5	1.7	1.3	2.4	1.9	1.8
III. Eastern Europe	**12914.5**	**3.4**	**13.5**	**10.3**	**7.8**	**2.4**	**2.8**	**7.0**	**21.0**	**22.1**	**17.9**	**0.9**	**1.0**	**1.0**
of which:														
1. Russia*	8573.5	1.4	6.5	8.1	5.9	1.4	1.8	4.5	13.7	18.3	16.1	0.6	0.7	0.7
IV. Developing Nations	**207173.5**	**11.8**	**14.6**	**15.7**	**18.6**	**43.2**	**44.5**	**14.8**	**19.8**	**19.2**	**17.1**	**41.7**	**43.5**	**44.1**
of which														
Asia	165831.6	5.7	3.3	11.4	14.0	34.8	35.6	6.9	10.8	13.4	14.4	29.2	32.0	32.9
(*a*) China	76271.7	—	—	—	0.1	16.0	16.4	—	—	—	0.1	3.4	3.7	4.4
(*b*) Hong Kong	16870.1	—	0.1	0.3	0.7	2.1	2.2	—	1.1	2.1	3.3	4.6	5.1	4.8
(*c*) South Korea	16301.8	—	—	1.1	1.5	3.3	3.5	—	—	0.7	1.0	1.3	1.5	1.5
(*d*) Singapore	7467	—	—	3.4	3.3	1.9	1.6	—	—	1.6	2.1	2.9	3.5	3.9
(*e*) Malaysia	9011.6	—	0.4	1.6	2.3	2.3	1.8	—	0.8	0.8	0.8	1.4	1.9	1.9
V. Others		**2.2**	**0.5**	**0.5**	**1.4**	**2.3**	**2.0**	**8.0**	**2.6**	**1.0**	**2.9**	**1.2**	**1.2**	**0.9**
Total		**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

*Refers to former USSR before 1992-93.

Source: Computed from (1) Reserve Bank of India, *Report on Currency and Finance,* Various Issues, and (2) Reserve Bank of India, *Handbook of Statistics on the Indian Economy,* 2016-17 (Mumbai, 2017), Table 134, p. 211.

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country. With the expansion of trading relations with Japan, West Germany and USSR, the dependence on the UK declined considerably. Thus, the share of UK in Indian imports declined from 19.4 per cent in 1960-61 to 1.0 per cent in 2017-18. On the other hand, the share of Japan increased from 1.5 per cent in 1950-51 to 7.5 per cent in 1990-91 but declined thereafter and stood at only 2.3 per cent in 2016-17.

Another significant development was the expansion in trading relations with the socialist countries especially the erstwhile USSR Imports from USSR were negligible in 1950-51. In 1960-61 they amounted to a meagre ₹ 16 crore. However, thereafter, they increased rapidly thanks to bilateral trade agreements with that country. In 1984-85, the share of USSR was 10.4 per cent and it displaced USA from the first place. The picture changed thereafter. In 1985-86, USA was first, Japan second and USSR third. In 1990-91, with a share of 12.1 per cent, USA occupied the first place. It was followed by Germany with a share of 8.0 per cent (the figure is for unified Germany). Japan had the third position (share 7.5 per cent). UK and Saudi Arabia shared the fourth position with a share of 6.7 per cent each, Belgium had the fifth position (share 6.3 per cent) while USSR had the sixth position (share 5.9 per cent). With the disintegration of USSR, the direction of imports changed markedly. ***In 2017-18, China occupied the first position in India's imports (share 16.4 per cent), followed by Iran (8.4 per cent), USA (5.7 per cent), Saudi Arabia (4.74 per cent), UAE (4.67 per cent), Switzerland (4.17 per cent), Iraq (3.75 per cent), Indonesia (3.53 per cent), South Korea (3.51 per cent), Australia (3.01 per cent), Germany (2.86 per cent) and Japan (2.4 per cent) in that order.***

Direction of Exports

As is clear from Table 36.4, OECD group accounts for a major portion of India's exports. The share of this group in 1960-61 was 66.1 per cent and in 2017-18 was 39.4 per cent. A little less than half of these exports were accounted for by the EU countries in 2017-18. The OPEC group accounted for 4.1 per cent of exports in 1960-61 and its share in 2017-18 rose to 14.6 per cent. Most significant was the rapid increase in exports to the countries of Eastern Europe particularly USSR. For instance, Eastern Europe accounted for 7.0 per cent of export earnings in 1960-61 and its share shot up to 22.1 per cent in 1980-81. During recent years, exports to this group have suffered a setback due to marked political upheavals in these countries and the disintegration of the USSR. In 2017-18, the share of Eastern Europe in total exports had slumped to a mere 1.0 per cent. Developing nations of Africa, Asia and Latin America accounted for 44 per cent of India's export earnings in 2017-18. Most important in this group have been the countries of Asia. In fact, exports to Asian countries accounted for 32.9 per cent of India's total export earnings in 2017-18. Important facts regarding India's country-wise exports are as under:

At the start of the planning process in India in 1950-51, the share of UK in India's total exports was as high as 23.3 per cent. This came down substantially to 11.1 per cent in 1970-71 and 3.2 per cent in 2017-18. The second position in 1950-51 and 1960-61 was occupied by USA, its share in India's exports being 19.3 per cent and 16.0 per cent in these years respectively. In fact, India was dependent for 42.6 per cent and 44.8 per cent of its export earnings on UK and USA in 1950-51 and 1960-61 respectively. Other capitalist countries and socialist countries purchased Indian goods on a very small scale. However, after 1960-61, India's trading relations with these countries expanded at a very rapid pace. Thus, USSR which purchased only ₹ 11 crore worth of goods from India in 1950-51 increased its purchases to ₹ 210 crore in 1970-71 and ₹ 2,006 crore in 1985-86. In fact, it occupied the *first* place in India's export earnings in that year followed by USA, Japan, UK and West Germany in that order. Thereafter, the position changed again and USA occupied the *first* position in 1986-87, 1987-88, 1988-89 and 1989-90. The *second* position was occupied by USSR in all these years while the *third* position was occupied by Japan. In 1990-91 USSR with a share of 16.1 per cent in India's export earning occupied the first position with USA (share 14.7 per cent) occupying the second position. Japan with a 9.3 per cent share occupied the third position. The position changed markedly thereafter due to the disintegration of the USSR. As is clear from Table 36.4, exports to Russia accounted for only 0.7 per cent of export earnings in 2017-18. ***In 2017-18, USA with a share of 15.8 per cent occupied the top position. It was followed by UAE (share 9.3 per cent), Hong Kong (4.8 per cent), China (4.4 per cent), Singapore (3.4 per cent), UK (3.2 per cent), Germany (2.9 per cent), Bangladesh (2.8 per cent), Nepal (2.2 per cent) and Belgium (2.1 per cent) in that order.***

GROWTH AND STRUCTURE OF INDIA'S FOREIGN TRADE SINCE 1991

Commencing July 1991, the Government of India has initiated a number of measures to 'open up' the foreign trade sector and has announced massive import liberalisation measures in recent years. These include devaluation of the rupee in July 1991 and subsequently its depreciation against the currencies of leading industrialised countries, introduction of the convertibility of rupee first on trade account and then

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for all current account transactions, liberalisation of import regime, substantial reduction in customs tariff rates, decanalising of many items of trade, wide ranging measures to give a thrust to exports, etc. In fact, the trade policy reforms initiated in 1991 have drastically changed the scenario and have resulted in a shift from the inward-oriented policy of the past to an outward-oriented policy. In this last section of the Chapter, we propose to discuss the growth and structure of India's foreign trade since 1991.

Expansion of Foreign Trade

India's trade has increased significantly in the post-reform period. In absolute terms, the trade volume rose from US $ 42.2 billion ($ 18.1 billion exports and $ 24.1 billion imports) in 1990-91 to US $ 844 billion in 2018-19 ($ 329.5 billion exports and $ 74 billion imports) in 2017-18. However, since 1992-93 the rate of increase of imports has been consistently higher than the rate of increase of exports (in dollar terms) excepting 1993-94, 2000-01, 2002-03, 2010-11, 2013-14 and 2016-17. As a result, trade deficit increased substantially from $ 1.5 billion in 1991-92 and $ 3.3 billion in 1992-93 to as high as $ 190.34 billion in 2012-13 (highest level recorded so far). However, it fell thereafter and stood at $ 108.5 billion in 2016-17. However, it rose to $ 184.5 billion in 2018-19.

Important observations regarding India's trade performance during the post-reform period are as follows:

1. Reflecting the liberalisation of trade regime and the increasing external openness of the economy, India's trade-GDP ratio showed substantial improvements in the post-1991 period as compared with the earlier decades. The export-GDP ratio rose from 4.5 per cent in 1970s (1970-71 to 1979-80) and 4.6 per cent in 1980s (1980-81 to 1989-90) to 7.8 per cent in 1990s (1990-91 to 1999-2000). It rose further to 17.2 per cent in 2013-14 but fell thereafter and stood at 11.9 per cent in 2017-18. 12.4 per cent in 2016-17. The import-GDP ratio also rose from 5.3 in 1970s to 7.2 per cent in 1980s and further to 9.3 per cent in 1990s. In 2017-18, the import-GDP ratio was 18.0 per cent. ***These data indicate an increasing openness of the Indian economy in the period since 1991 and given India's own economic past "represents a significant change in its relationship with the world economy."***[7]

2. The export-import ratio (which indicates the proportion of imports that can be financed from export earnings) increased substantially from 64.0 per cent during 1980s to 84.9 per cent during 1990s and stood at 81.7 per cent in 2003-04. However, it deteriorated thereafter and fell to 75 per cent in 2004-05 and 64 per cent in 2018-19.

3. Both export growth and import growth rates registered an increase in the post-reform period *vis-à-vis* 1980s. For instance, the average annual export growth rate rose from 8.1 per cent in 1980s to 8.6 per cent in 1990s and further to 13.4 per cent over the period 2000-01 to 2016-17 while the average annual import growth rate rose from 7.2 per cent in 1980s to 9.6 per cent in 1990s and further to 14.0 per cent over the period 2000-01 to 2016-17.

Changes in Composition of Exports

Important changes have taken place in the composition of exports during the post-reform period as would be clear from the discussion below:

1. The share of agriculture and allied products in total exports was 19.4 per cent (*i.e.*, one-fifth) in 1990-91. This fell to 11.8 per cent in 2018-19.

2. Manufactured products account for a major share of the increase in aggregate exports over the period 1990-91 to 2018-19. It can be calculated from Table 36.3 that of the total increase in export earnings of $ 3,11,929 million over the period, exports of manufactured goods accounted for as much as $ 2,31,953 million, *i.e.*, 70.3 per cent (or, almost three-fourths).

3. Engineering goods occupied the third place in India's export earnings in 1990-91 with a share of 11.9 per cent. In 2018-19, they occupied the first place with a share of 28.7 per cent. Thus, ***engineering goods now contribute more than one-fourth of total export earnings***. Their share in incremental export earnings over the period 1990-91 to 2018-19 is as high as 28.0 per cent ($ 90,292 million out of $ 2,57,709 million).

4. Exports of petroleum products were only $ 528 million in 1990-91. They rose to as high as $ 47,874 million in 2018-19 which was 14.75 per cent of total exports.

Exports of petroleum exports were non-occupy the second place in India's export earnings after engineering goods.

5. Gems and jewellery was the most important export item in 1990-91 with its share in total export earnings being 16.1 per cent. With 12.2 per cent share in export earnings in 2018-19, gems and jewellery occupied the ***third*** position in this year.

6. Exports of chemicals and allied products which were $ 1,176 million in 1990-91 rose to $ 37,840 million in 2018-19. As a result, the percentage share of chemicals and allied products increased from 6.5 per cent in 1990-91 to 11.9 per cent in 2018-19. An important reason for this improved performance has been an increase in the exports of drugs, pharmaceuticals and fine chemicals.

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7. The second most important export item in 1990-91 was readymade garments with their share in export earnings being 12.8 per cent. However, it was soon pushed down to third place by engineering goods. In 2018-19, the share of readymade garments in export earnings was 5.3 per cent.

8. The share of leather and leather manufactures in export earnings declined steeply from 8 per cent in 1990-91 to 3.4 per cent in 2003-04 and further to 1.6 per cent in 2018-19.

9. Because of the rising demand for iron ore by Chinese iron and steel industry, the exports of iron ore from India suddenly shot up. While iron ore worth $ 1,126 million was exported in 2003-04, in a year's time (*i.e.,* in 2004-05) the exports of iron ore jumped to $ 3,277 million. However, they fell to just $ 525 billion in 2014-15 and further to $ 191 million in 2015-16 because of restrictions on iron ore mining on the one hand and demands of domestic iron and steel industry on the other hand. However, exports of iron ore again shot up to $ 1,471 million in 2017-18 and stood at $ 1,310 million in 2018-19.

10. The changes in the structure of India's exports during the post-reform period are more noticeable at the disaggregated level. In certain years during this period, exports of rice, tobacco, spices, sugar and molasses, and works of art (excluding floor coverings) increased significantly.

11. India's manufacturing exports are showing tendencies of shifting away from traditional exports towards relatively manufactured products. An encouraging trend from the point of view of future growth is that in recent years, ***exports of electronic goods and computer goods have shown good performance.*** For example, exports of electronic goods were worth $ 1,832 million in 2004-05. They rose to $ 3,361 million in 2007-08 and further to $ 6,394 million in 2018-19.

12. In addition to changes in the composition of merchandise exports, it is also necessary to emphasise the sharp rise in service exports since 1991 and changes in the composition of service exports. ***Between 1992 and 2018-19, India's exports of services increased from $ 4.9 billion to $ 195.1 billion.*** As far as composition of service exports is concerned, the relative share of travel and transportation in India's exports which was as high as 64 per cent in 1995-96 fell to 23.5 per cent in 2018-19, while that of software services rose from 10 per cent to 39.6 per cent over the period.

13. Another promising area that is emerging is project exports. There is a growing realisation across Asia and Africa that the experience of Indian companies is more appropriate to their project needs, especially in hydro-power, irrigation, transportation and water supply systems. As a result, export of projects and services including construction and industrial turnkey projects and consultancy services is increasing.

Changes in Composition of Imports

Important observations regarding the composition of India's imports and structural changes therein during the post-reform period are as follows:

1. ***The most important import item in terms of expenditure is POL (petroleum, oil and lubricants).*** The share of POL in total import expenditure was 25.0 per cent in 1990-91 and 27.4 per cent in 2018-19. In fact, ***for most of the post-reform period, POL imports have accounted for one-fourth (or more than one-fourth) of total import expenditure.***

A point that needs to be noted here is the compositional shifts within the broad level of aggregation during the last decade and a half. For instance, within the petroleum imports, there has been a shift from import of petroleum products towards crude imports following a large-scale increase of refinery capacity over time. Furthermore, India transformed itself from a net importer of finished petroleum products to net exporter of the same in 2001-02.[8]

2. To meet the requirements of the gems and jewellery industry (which is an important export industry of the country) pearls and precious and semi-precious stones are imported in large quantities. These imports amounted to $ 2,083 million in 1990-91 and $ 27,078 million in 2018-19.

3. As is clear from Table 36.2, imports of capital goods at $ 5,833 million in 1990-91 accounted for 24.2 per cent (*i.e.,* almost one-fourth) import expenditure in 1990-91. For most of the post-reform period, imports of capital goods have accounted for almost one-fourth of import expenditure. In 2018-19, of the total imports of $ 5,14,634 million, imports of capital goods were $ 1,28,625 million, *i.e.*, 25.0 per cent of total imports.

4. As a result of liberalisation of trade policy in the post-reform period and changing consumer tastes, imports of electronic goods and computer goods have increased substantially during the recent years. During 1993-94, imports of electronic goods and computer goods were worth $ 930.4 million which was just 4 per cent of total import expenditure. In 2000-01, their imports had risen to $ 3,694.5 million which was 7.3 per cent of total import expenditure. In 2018-19, imports of electronic goods alone stood at $ 57,571 million which was 11.2 per cent of total import expenditure.

5. There has been a steep fall in the imports of project goods in recent period. The share of import of project goods in total import expenditure was 6.3 per cent in 1998-99 which fell drastically to only 0.4 per cent in 2017-18.

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6. The share of fertilisers in import expenditure fell from 4.1 per cent in 1990-91 to only 1.3 per cent in 2016-17. The share of iron and steel in import expenditure fell from 4.9 per cent to 2.4 per cent in 2018-19.

7. The share of chemical elements and compounds in total import expenditure remained stable at 5-6 per cent all through the period 1990-91 to 2005-06 and was 6.1 per cent in 2018-19.

8. Data on imports of gold and silver since 1999-2000 are now available (the reason is that these imports are now channelised through the official routes). These data show that gold and silver imports were of $ 4,706 million in 1999-2000 and these rose to $ 36,871 million in 2018-19. Percentage share of gold and silver in total import expenditure was 7.9 per cent in 2018-19.

Direction of Imports in the Post-Reform Period

As is clear from Table 36.4, the share of OECD group of countries declined from 54.0 per cent in India's imports in 1990-91 to 27.7 per cent in 2017-18. The main reason for this was a fall in the share of EU from 29.4 per cent in 1990-91 to 10.3 per cent in 2017-18. The share of Eastern Europe which was 7.8 per cent in 1990-91 fell drastically to only 2.4 per cent in 2017-18 because of the setback to socialist bloc and particularly the disintegration of USSR. The share of OPEC countries which was 16.3 per cent in 1990-91 rose to 23.9 per cent in 2017-18. The share of developing countries in India's imports was 18.6 per cent in 1990-91 and 44.4 per cent in 2017-18. Of these, imports from Asian countries are the most important.

As far as the share of different countries in India's imports is concerned, USA occupied the first position in 1990-91 with a share of 12.1 per cent followed by Germany (share 8.0 per cent), Japan (share 7.5 per cent), UK and Saudi Arabia (share 6.7 per cent each) and Belgium (share 6.3 per cent) in that order. In 2017-18, China occupied the first position in India's imports (share 16.4 per cent), followed by USA (5.7 per cent), Saudi Arabia (4.74 per cent), UAE (4.67 per cent), Switzerland (4.15 per cent), Iraq (3.78 per cent), Indonesia (3.53 per cent), South Korea (3.51 per cent), Australia (3.0 per cent), and Germany (2.9 per cent) in that order.

Direction of Exports in the Post-Reform Period

The OECD group of countries accounted for more than half of India's export earnings during 1990s. Their share in India's exports was 53.5 per cent in 1990-91 which fell to 39.4 per cent in 2017-18. In 1990-91, almost half of the exports to OECD countries were accounted for by EU countries. Taken separately, EU accounted for 21.8 per cent of India's export earnings in 1990-91 and 17.7 per cent in 2017-18. The share of OPEC group in India's export earnings was 5.6 per cent in 1990-91 which rose to 14.6 per cent in 2017-18. Because of the disintegration of communist regimes, the share of Eastern Europe in India's export earnings fell drastically from 17.9 per cent in 1990-91 to 10.9 per cent in 1991-92 and to merely 1.0 per cent in 2017-18. What is significant from India's point of view is the fact that the share of developing nations of Africa, Asia and Latin America has risen considerably over the twenty-three year period 1990-91 to 2017-18 from 17.1 per cent to 44.1 per cent. Most important in this group have been the countries of Asia. In fact, these countries accounted for 32.0 per cent of India's export earnings in 2016-17.

As far as the share of different countries in India's export earnings is concerned, USSR with a share of 16.1 per cent occupied the first position in 1990-91. USA occupied the second position with a share of 14.7 per cent followed by Japan (share 9.3 per cent). The position changed markedly thereafter due to the disintegration of the USSR. As is clear from Table 36.4, Russia accounted for only 0.7 per cent of India's export earnings in 2018-19. In this year, USA with a share of 15.8 per cent occupied the first place. It was followed by UAE (share 9.3 per cent), Hong Kong (4.8 per cent), China (4.7 per cent), Singapore (3.4 per cent), UK (3.2 per cent), Germany (2.9 per cent), Bangladesh (2.8 per cent), Nepal (2.2 per cent) and Belgium (2.1 per cent in that order).

Table 36.4 and the discussion above show that significant changes have taken place in the direction of India's foreign trade since 1991 and more particularly during the last few years. What is significant is the emergence of China, Singapore, Hong Kong, South Korea and Malaysia as important trading partners from the Asian region, Switzerland from OECD countries, and UAE and Indonesia from OPEC.

Trade Deficit and Trade Surplus Countries

Among India's trading partners, the top five countries with which India's bilateral trade balance was negative in 2017-18 were China, Switzerland, Saudi Arabia, Iraq and South Korea, while the top five countries with which it had surplus trade balance in this year were USA, UAE, Bangladesh, Nepal and UK. As is clear from Table 36.5, the major contributor to India's total trade deficit is its trade deficit with China, the share of which increased from 20.3 per cent in 2012-13 to 38.8 per cent in 2017-18.

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Table 36.5

Bilateral Trade Surplus/Deficit (US $ billion)

Trade Surplus Countries	*2012-13*	*2014-15*	*2015-16*	*2016-17*	*2017-18*
USA	11.0	20.6	18.6	19.9	21.3
UAE	2.8	6.9	10.8	9.7	6.4
Bangladesh	4.5	5.8	5.3	6.1	7.8
Nepal	2.5	3.9	3.5	5.0	6.2
UK	2.3	4.3	3.6	4.9	4.8
Trade Deficit Countries					
China	38.7	48.5	52.7	51.1	62.9
Switzerland	31.0	21.1	18.3	16.3	17.8
Saudi Arabia	24.2	16.9	13.9	14.9	16.6
Iraq	18.0	13.4	9.8	10.6	16.1
South Korea	8.9	8.9	9.5	8.3	11.9
Total Trade Deficit	**190.3**	**137.6**	**118.7**	**108.5**	**162.2**

Source: Reserve Bank of India, *Handbook of statistics on Indian Economy* 2017-18, Table 128, p. 197.

NOTES

1. World Bank, *World Development Report* 1987, p. 81.
2. See, for instance, S.J. Patel, "Export Prospects and Economic Growth in India", *The Economic Journal*, LXIX (Sept. 1959), pp. 490-506. Reprinted in abridged form in C.D. Wadhwa (ed.), *Some Problems of India's Economic Policy* (New Delhi, 1977), pp. 580-9.
3. Government of India, *Economic Survey* 2015-16 (Delhi, 2016), Volume II, p. 70.
4. Reserve Bank of India, *Annual Report* 2015-16 (Mumbai, 2016), p. 37.
5. Reserve Bank of India, *Annual Report* 2016-17 (Mumbai, 2017), p. 57.
6. Government of India, *Economic Survey* 2007-08 (Delhi, 2008), p. 118.
7. Reserve Bank of India, *Report on Currency and Finance* 2000-01 (Mumbai, 2002), Table 6.1.
8. Reserve Bank of India, *Report on Currency and Finance* 2002-03 (Mumbai, 2004), p. 108.

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37 Chapter

INDIA'S BALANCE OF PAYMENTS

In this chapter, we shall discuss:

- Meaning of balance of payments
- India's balance of payments problem in the pre-reform period
- Balance of payments situation in India since 1991 and the causes for satisfactory position
- Issues relating to the management of balance of payments.
- Challenges and outlook

MEANING OF BALANCE OF PAYMENTS

A balance of payments statement is essentially a double-entry system of record of all economic transactions between the 'residents' of a country and the rest of the world carried out in a specific period of time. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents, and payments made by them on account of goods imported and services received from, and capital transferred to 'non-residents' or foreigners. Thus, balance of payments is a much wider term as compared to balance of trade. Whereas the latter refers only to merchandise imports and exports, the former refers to all economic transactions with the outside world.

The balance of payments statement is divided into two major accounts, *viz.*, current account and capital account. Transactions relating to goods, services and income constitute the current account, while those relating to claims and liabilities of a financial nature, which go to finance the deficit on current account or to absorb its surplus, form the capital account. The sum of these current and capital account transactions together constitutes the basic balance on the balance of payments and theoretically it should be finally rounded up and the double-entry accounting should be closed with the help of: (*a*) purchases and repurchases from the IMF essentially as an international agency for the country's balance of payments support, (*b*) allocation of the IMF's Special Drawing Rights (SDRs) which was intended to supplement the relatively inadequate international reserves and also serve as a principal reserve asset of the international monetary system, and (*c*) the build-up or drawn-down of the country's own reserve assets. This is the theoretical position. However, because of inaccurate estimation, clandestine capital flight and various other discrepancies, the credit side of the double-entry accounting does not match the sum of all debt entries. Therefore, the balancing act is performed by an item called 'errors and omissions' — a negative sign in it implying an overstatement of receipts or understatement of payments, generally a combination of both, and a positive sign signifying the reverse.

Current Account. The transactions relating to goods, services and income, constituting the current account on the balance of payments, are functionally classified into two broad categories: merchandise and invisibles. As per the IMF's *Balance of Payments Manual,* imports and exports of goods (merchandise) should be presented on a free-on-board (f.o.b.) basis, *i.e.,* without including freight and insurance costs. Such freight and insurance costs should logically be covered under 'invisibles'. However, due to data constraints, the Indian authorities present imports on c.i.f. (cost, insurance and freight) basis while the exports are presented on f.o.b. basis.

As far as 'invisibles' are concerned, they comprise costs of services, income, and transfer payments (*i.e.,* payments and remittances unrequited or without *quid pro quo* or without any repayment obligations). The *IMF Manual* classifies invisible account into as many as 21 items while the Indian authorities provide the 'invisibles' account data only under the following 8 heads: (1) travel, (2) transportation, (3) insurance, (4) investment income, (5) government, not included elsewhere, (6) miscellaneous (receipts/payments for patents and royalties), (7) transfer payments — official, and (8) transfer payments — private.

Capital Account. Capital account in India is classified into three main sectors: (*i*) private capital, (*ii*) banking capital, and (*iii*) official capital. Private capital is sub-divided into (*a*) long-term and (*b*) short-term, with loans of an original maturity of one year or less constituting the relevant dividing line. Long-term private capital covers foreign investments (both direct and portfolio), long-term loans,

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foreign currency deposits (FCNR and NRER) and an estimated portion of the unclassified receipts allocated to the capital account. Banking capital essentially covers movements in the external financial assets and liabilities of commercial and cooperative banks authorised to deal in foreign exchange. Official capital transactions, RBI's holdings of foreign currency assets and monetary gold (SDRs are held by the government), are classified into (*i*) loans, (*ii*) amortisation, and (*iii*) miscellaneous receipts and payments.[1]

Since balance of payments accounts are prepared on the double-entry system of accounting, sum of all debits equals the sum of all credits and the accounts are always in balance. However, this does not mean that a country cannot face balance of payments difficulties. If a country faces a deficit in its current account and this is met by liquidation of its assets or through borrowing abroad, it is indeed facing a balance of payments difficulty. If such steps have to be resorted to repeatedly, a serious balance of payments problem can result forcing the country to draw down its foreign exchange reserves and borrow at high rates of interest from international markets (if requisite amount of concessional aid is not available). The burden of debt repayment is likely to increase substantially under such circumstances jeopardising the long-run economic and political interests of the country.

INDIA'S BALANCE OF PAYMENTS: THE PRE-1991 PERIOD

When India became Independent, it had a 'sterling balance' of ₹ 1,733 crore. This was the result of a sizeable surplus on balance of trade with the UK during the Second World War Period when UK had made large-scale purchasing from India to meet its war requirements. The foreign exchange position of the country was therefore satisfactory. However, the immediate post Independence period was characterised by the release of 'pent-up demand' for imports (suppressed during the War) and shortages of food and raw materials. Thus, import bill increased substantially while exports remained stagnant. The deficit had to be made good from the sterling balances.

During the first plan period, the overall deficit in the balance of trade was ₹ 541.9 crore. However, due a substantial surplus on the invisible account the balance of payments situation was satisfactory. In fact, the deficit on current account was only ₹ 42.3 crore.

Bimal Jalan divides the period after 1956-57 into three sub-periods depending on the nature of the balance of payments problems, the overall macroeconomic environment and the external aid situation. The three sub-periods are: 1956-57 to 1975-76 (period I), 1976-77 to 1979-80 (period II) and 1980-81 to 1990-91 (period III).[2] While periods I and III were characterised by persistent balance of payments problem, period II saw a substantial improvement in the balance of payments and the foreign exchange reserve position. ***Jalan used the following two criteria as a rough measure of the balance of payments problem in a particular year: (i) the current account deficit was more than one per cent of GDP and (ii) the foreign exchange reserves were less than necessary to cover three months' imports.*** During period II, the current account deficit was less than one per cent of GDP and reserves were sufficient to cover more than three months' imports. As against this, current account deficit was more than one per cent of GDP in periods I and III. However, in both these periods, there were some years during which reserves exceeded three months' imports. But, on the whole, the overall balance of payments situation continued to be difficult.

Current Account Deficit in Balance of Payments

Period I: 1956-57 to 1975-76. ***This period comprising the Second, Third and Fourth plans and first two years of the Fifth Plan saw heavy deficits in balance of payments and an extremely tight payments position.*** Let us now consider briefly the position in the different Plans falling in this period. The development strategy adopted in the Second Plan gave primary importance to the establishment and development of basic and capital goods industries. This necessitated large-scale imports of capital equipment, machinery and technical know-how. Throughout the Second Plan period, exports were stagnant and the value of imports was almost double the value of exports. As a result, the deficit in balance of trade was ₹ 2,261.3 crore. The only redeeming feature was that receipts on invisibles remained positive as in the First Plan and, as a result, the overall deficit on current account was reduced to ₹ 1,646 crore.[3] The overall deficit in the balance of payments during the Third Plan was ₹ 1,972 crore.

As far as Fourth Plan is concerned, it registered continuous increase in imports mainly due to increase in international prices. For example, the Organisation of Petroleum Exporting Countries (OPEC) resorted to a substantial increase in the price of crude oil from $ 2.50 and $ 3.00 per barrel in the middle of 1973 to $ 11.65 per barrel in early 1974, *i.e.*, by about four times. The prices of fertilisers, iron and steel, non-ferrous metals and various types of capital equipment also increased substantially in 1972-73 and 1973-74 (the last two years of the Fourth Plan). As a result, the deficit on current account during the Fourth Plan was as high as ₹ 2,221 crore. The first two

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years of the Fifth Plan (1974-75 and 1975-76) recorded a deficit of ₹ 1,738 crore in the current account.

Period II: 1976-77 to 1979-80. This relatively short period was a ***golden period*** as far as the balance of payments is concerned. ***India had a small current account surplus of 0.6 per cent of the GDP during this period and also possessed foreign exchange reserves equivalent to about seven months' imports.*** The relatively comfortable position on the balance of payments front was due to the following factors: (1) First and foremost was the rapid increase in private remittances from oil exporting countries. A large number of Indian workers temporarily migrated to the oil-rich middle east countries to work there as unskilled workers, skilled technicians, office assistants, nurses etc. They kept sending their net earnings to their families in India. As a result, transfer payments to India on private account aggregated ₹ 3,128.7 crore over the Fifth Plan period; (2) There was a strong growth in exports of nearly 31 per cent in 1975-76 over 1974-75 and of 23 per cent in 1976-77 over 1975-76 (in rupee terms); (3) As a result of the conservation measures adopted domestically and increase in oil production, the country was able to arrest the growth in oil imports; (4) There was a substantial expansion in the activities of Indian firms in the oil exporting middle east countries. Indian firms were building roads, airports, housing estates, power stations, steel mills, etc., in a number of middle-east countries. These exports of construction services as well as of some materials contributed substantially to India's foreign exchange earnings; and (5) Aid receipts were reasonably buoyant and India drew on various International Monetary Fund facilities during the years 1973-74 to 1975-76. Over the next three years, by the time of the second oil shock, India had already repurchased the Fund drawings.[4]

Period III: 1980-81 to 1990-91. ***This period covering roughly the Sixth Plan (1980-81 to 1984-85) and Seventh Plan (1985-86 to 1989-90) was marked by severe balance of payments difficulties.*** In fact, during the first four years of the Sixth Plan (1980-81 to 1983-84), the deficit in balance of trade was around ₹ 6,000 crore per annum. In the last year of the Plan 1984-85 this shot upto ₹ 6,721 crore. The trade deficit in the first three years of the Seventh Plan (1985-86 to 1987-88) exceeded ₹ 9,000 crore per annum and in the fourth and fifth years (1988-89 and 1989-90) exceeded ₹ 12,000 crore per year. ***In 1990-91, the deficit touched the astronomical figure of ₹ 16,934 crore.*** This shows the difficult position that the country faced on the balance of payments front.

Earnings from invisibles were substantial throughout the Sixth Plan period. They touched the highest level ever in the planning period during 1980-81. In that year they stood at ₹ 4,311 crore. In subsequent years of the plan, earnings from invisibles declined somewhat but in each year they were ₹ 3,500 crore or more. However, during the Seventh Plan period private remittances from middle-east countries showed tendencies of flattening out. As a result, earnings from invisibles declined consistently and fell to ₹ 1,025 crore in 1989-90. Whereas net invisibles financed, on an average, more than 60 per cent of trade deficit during the Sixth Plan, they financed only 24 per cent of trade deficit during the Seventh Plan. The Gulf crisis during the year 1990-91 further worsened the balance of payments problem. In addition to a massive trade deficit of ₹ 16,934 crore, there was a deterioration in the invisibles account as well because of lower remittances and higher interest payments. ***The current account deficit soared to ₹ 17,369 crore in this year.***

Capital Account: Financing The Deficit

A study of capital account of the balance of payments reveals the methods of financing the deficit in the current account of the balance of payments. ***In periods I and II, the entire deficit was financed through inflows of concessional assistance and this kept the debt servicing burden low. In contrast, a substantial part of the deficit (indeed almost the entire incremental deficit, in dollar terms) had to be financed through non-concessional loans obtained on market related terms during period III.*** As noted by Jalan, disbursements on concessional terms constituted more than 89 per cent of assistance to India from multilateral sources in 1980. This proportion declined to about 35 per cent in 1990. The average maturity of loans from official sources also declined from 40.8 years in 1980 to 29.1 years in 1990.[5] At the same time, the average rate of interest increased. Thus there was a deterioration in the 'quality' of external financing. As a result, the total debt increased from ₹ 19,470 crore in 1980-81 to as high as ₹ 1,63,001 crore at end-March 1991. ***After 1984-85, the large current account deficit had to be financed through substantial inflows of capital by way of commercial borrowings and deposits by non resident Indians (NRIs).*** This increased the cost of external debt considerably over time. As a result, the debt-service ratio rose to 35.3 per cent in 1990-91 and stood at 30.2 per cent in 1991-92. The debt to GDP ratio also rose significantly to 41.0 per cent in 1991-92. The country also had to seek a substantial assistance from IMF (International Monetary Fund).

In addition to the difference in the sources of financing (i.e., concessional vs. non-concessional) between Period I and Period III, Bimal Jalan points out another difference. In contrast to Period I, the macroeconomic policy in Period III was highly expansionary. The combined fiscal deficit of the Centre and States which was less than 6 per cent of

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GDP in Period I rose considerably in Period III and reached 12.1 per cent in 1990-91. During Period III, the government also resorted to a policy of import liberalisation and industrial liberalisation. In fact, over the second half of the 1980s (1985-86 to 1990-91) imports, in rupee terms, grew at an average annual rate of 17 per cent. This sharp growth in imports could not be supported by our own exports, other receipts and normal aid flows. Consequently, they had to be financed by commercial borrowings or other borrowing on hard terms. As noted by Jalan, even this could be sustained only as long as such loans were available. The economy was plunged into a crisis as soon as these sources of financing dried up. "The roots of the crisis, therefore, do not lie in import liberalisation *per se* but in the overall framework of macroeconomic policies including fiscal policy, which permitted an expansion of internal demand for the home market without generating adequate exports during a period when the external environment for aid to India was deteriorating. Such liberalisation, as there was, was 'inward looking' and higher growth of the domestic economy was financed by external loans on hard terms. As events have unfolded, this has proved to be a mistake."[6]

BALANCE OF PAYMENTS SITUATION SINCE 1991

The balance of payments situation since 1991 has been distinctly different from the situation that prevailed in the earlier period excepting the years 1991-92 and 1992-93. Since 1991-92 was an exceptional year, it is left out of discussion. Consequently, Table 37.1 on balance of payments situation since 1991 starts from the year 1992-93.

The situation in 1992-93 (the first year of the Eighth Plan) was bad as imports grew by 15.4 per cent on balance of payments basis while the growth of exports was just 3.3 per cent on balance of payments basis. The import cover of foreign exchange reserves was only 4.9 months in this year. However, balance of payments situation improved considerably in 1993-94 with exports increasing by 20.2 per cent on balance of payments basis as against only 10.2 per cent increase in imports. The current account deficit in this year was $ 1,158 million which was just 0.4 per cent of GDP. With capital account surplus of $ 9,882 million, there was a reserve accumulation of as much as $ 8.7 billion (see Table 37.2). The import cover of foreign exchange reserves rose to eight-and-a-half months in this year while it was only 4.9 months in 1992-93. All these facts show that ***there was a marked 'turnaround' in the balance of payments situation in 1993-94.*** The situation in other years of the Plan was also satisfactory excepting the year 1995-96 when the deficit in balance of trade rose to as high as $ 11,360 million. Current account deficit in this year was $ 5,910 million while capital account surplus was only $ 2,975 million. As a result, there was a foreign exchange reserve drawdown of $ 2.9 billion.

The balance of trade in 1997-98 (the first year of the Ninth Plan) was – $ 15,507 million while earnings from invisibles were $ 10,007 million. As a result, deficit in current account was $ 5,500 million (which was 1.4 per cent of GDP). However, the balance of payments position remained comfortable with reserve accumulation of $ 3.9 billion supported by strong private capital inflows. Reserve accumulation rose to $ 6.1 billion in 1999-2000 and stood at $ 5.8 billion in 2000-01.

From the point of view of balance of payments, most significant have been the last year of the Ninth Plan, 2001-02 and the first two years of the Tenth Plan, 2002-03 and 2003-04. In these three years, ***there was a surplus on current account.*** The surplus on current account was 0.7 per cent of GDP in 2001-02, 1.2 per cent of GDP in 2002-03 and 2.3 per cent of GDP in 2003-04. ***It is the first time in post-Independence period that there was a current***

Table 37.1

India's Balance of Payments Situation Since 1991: Some Indicators

Indicator	*1992-93*	*1993-94*	*1995-96*	*2001-02*	*2007-08*	*2008-09*	*2012-13*	*2014-15*	*2015-16*	*2016-17*	*2017-18*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*	*(12)*
1. Current account balance (as % of GDP)	–1.4	–0.4	–1.7	0.7	–1.3	–2.3	–4.8	–1.3	–1.1	–0.6	–1.9
2. Import cover of foreign exchange reserves (no. of months)	4.9	8.6	6.0	11.5	14.4	9.8	7.0	8.9	10.9	11.3	10.9
3. Imports, dollar values (annual growth rate)	15.4	10.0	21.6	–2.8	35.1	19.7	0.5	–1.0	–14.1	–0.1	19.5
4. Exports, dollar values (annual growth rate)	3.3	20.2	20.3	–1.6	28.9	13.7	–1.0	–0.6	–15.9	5.2	10.3

Source: Calculated from Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Table 143, p. 226 and Table 238, p. 368.

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account surplus for three consecutive years. This surplus was also accompanied by strong net capital inflows (see Table 37.2). As a result, there was substantial reserve accumulation. The reserve build-up rose to as high as $ 31.4 billion in 2003-04.

After recording a surplus for three years in a row, the current account once again recorded a deficit in 2004-05. The current account deficit in this year was $ 2,470 million which rose to $ 9,902 million in 2005-06 and stood at $ 9,565 million in 2006-07. The main reason for high current account deficit was a rise in petroleum, oil and lubricants (POL) imports following a rise in oil prices. However, because of substantial capital inflows, there was significant reserve accumulation in all these years. Reserve accumulation in 2006-07 (the last year of the Tenth Plan) was as high as $ 36.6 billion.

The first year of the Eleventh Plan (2007-08) saw a marked increase in trade deficit to $ 91,467 million due to sustained demand for non-oil imports and escalation in international crude prices. Net surplus under invisibles, however, remained buoyant led by high growth in private transfers and software exports, thereby offsetting a significant part of the trade deficit. Consequently, as a result of sustained surplus in invisibles account, current account deficit was $ 15,737 million. This year also saw a surge in net capital inflows led by portfolio investment, external commercial borrowings and foreign direct investments. With net capital inflows far exceeding current account deficit, foreign exchange reserves in this year increased by an unprecedented $ 92.16 billion ***(the highest level recorded so far)***. Import cover of foreign exchange reserves was a comfortable 14.4 months. However, the situation deteriorated considerably in 2008-09 because of global recession. The demand for Indian exports was hit hard on the one hand, and there were large scale withdrawals from the capital account by the foreign institutional investors due to recession in their economies on the other hand (in fact, the foreign portfolio investment which was $ 27,433 million in 2007-08 turned negative to $ 14,030 million in 2008-09). There was a massive trade deficit of $ 119.5 billion while earnings from invisibles were $ 91.6 billion. As a result, current account deficit was $ 27.9 billion. With capital inflows (net) of only $ 7.8 billion, ***there was a loss of reserves amounting to $ 20.1 billion.***

During 2009-10, both exports and imports declined reflecting the impact of global recession. The current account deficit in this year was $ 38.2 billion while capital inflows (net) were $ 51.6 billion. As a result, foreign exchange reserves increased by $ 13.44 billion. The year 2010-11

Table 37.2

India's Balance of Payments: 1993-94 to 2016-17

(US $ million)

Year	Trade Balance	Invisibles (Net)	Current Account (Net)	Capital Account Total (Net)	Reserve Use (–increase)
(1)	(2)	(3)	(4)	(5)	(6)
1993-94	– 4056	2898	– 1158	9694	– 8536
1994-95	– 9049	5680	– 3369	–9156	– 5787
1995-96	– 11360	5448	– 5912	4690	+ 1223
1996-97	– 14815	10196	– 4019	11413	– 6794
1997-98	– 15507	10008	– 5499	10010	– 4511
1998-99	– 13246	9208	– 4038	8260	– 4223
1999-2000	– 17841	13143	– 4698	11100	– 6402
2000-01	– 12460	9794	– 2666	8530	– 5864
2001-02	– 11574	14974	3400	8358	– 11757
2002-03	– 10690	17035	6345	10640	– 16985
2003-04	– 13718	27801	14083	17338	– 31421
2004-05	– 33702	31232	– 2470	28629	– 26159
2005-06	– 51904	42002	– 9902	24954	– 15052
2006-07	– 61782	52217	– 9565	46171	– 36606
2007-08	– 91468	75730	– 15738	107902	– 92164
2008-09	– 119520	91604	– 27916	7836	+ 20080
2009-10	– 118203	80022	– 38181	51622	– 13441
2010-11	– 127322	79269	–48053	61103	–13050
2011-12	–189759	111604	–78155	65324	+12831
2012-13	–195656	107493	–88163	91989	–3826
2013-14	–147609	115313	–32296	47804	–15508
2014-15	–144940	118081	–26859	88265	–61406
2015-16	–130079	107928	–22151	40056	–17905
2016-17	–112442	98026	–14417	35967	–21550
2017-18	–160036	111319	–48717	92292	–43574

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2013-14 (Mumbai, 2014), Table 142, p. 229 and *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Table 137, p. 212.

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registered a high trade deficit of $ 130.6 billion. However, because of strong positive earnings of $ 84.6 billion from invisibles, current account deficit was $ 45.9 billion. With capital inflows (net) at $ 59 billion, there was a reserve accumulation of $ 13.0 billion.

Things deteriorated considerably during 2011-12. Trade deficit in this year rose to the high level of $ 189.76 billion (primarily because of a substantial increase in oil imports and gold imports). However, due to a robust growth in invisibles to $ 111.60 billion, the current account deficit in this year was contained at $ 78.16 billion but as a percentage of GDP, it crossed the sustainable level of 2.5 per cent of GDP and touched the high level of 4.2 per cent of GDP. There was a foreign exchange drawdown of $ 12.8 billion as net inflows under capital and finance account were less than adequate to finance the current account deficit.

Trade deficit in the first year of the Twelfth Plan, 2012-13, rose to $ 195.6 billion (the highest level recorded so far). Net earnings from invisibles were $ 107.5 billion leaving a current account deficit of $ 88.2 billion which was as high as 4.8 per cent of GDP. However, there was a marked improvement in 2013-14 with the current account deficit being contained at $ 32.4 billion as against $ 88.2 billion in 2012-13. This improvement was basically due to a reduction in trade deficit by as much as $ 48.0 billion (from $ 195.6 billion in 2012-13 to $ 147.6 billion in 2013-14). ***Of the total reduction of $ 48.0 billion in trade deficit, reduction in imports of gold and silver contributed approximately 47 per cent, reduction in non-POL and non-gold imports constituted 40 per cent, and change in exports constituted 25 per cent. Higher imports under POL and non-DCCI&S (Directorate General of Commercial Intelligence and Statistics) imports contributed negatively to the process of reduction to the extent of 12 per cent in 2013-14 over 2012-13.*** As a proportion of GDP, the CAD was only 1.7 per cent of GDP in 2013-14. Since net capital inflow in 2013-14 was $ 47.9 billion while CAD was $ 32.4 billion, there was a reserve accretion of $ 15.5 billion. The accretion to reserves helped in increasing the level of foreign exchange reserves above the $ 300 billion at end-March 2014.[7]

As can be seen from Table 37.1, both exports and imports declined in 2014-15 *vis-a-vis* 2013-14. While collapse in international commodity prices (particularly of crude oil) led to a fall in import expenditure, weak global demand and domestic structural constraints impacted the growth of exports adversely. On the other hand, earnings from invisibles increased somewhat. The combination of these factors restrained the current account deficit within sustainable limits (at 1.3 per cent of GDP). Capital inflows (net) increased considerably (from $ 47.9 billion in 2013-14 to $ 88.3 billion in 2014-15) because of increased foreign investments (both direct and portfolio) following major liberalisation measures announced, expectations of structural reforms and ebullient optimism surrounding political change.[8] Reserve accumulation in 2014-15 was as high as $ 61.4 billion (whereas it was only $ 15.5 billion in 2013-14).

India faced a testing international environment in 2015-16, as did other EMEs (emerging market economies), with still weakening global trade and growth rendering external demand anaemic. Even as the drag from external demand pulled down exports, imports continued to shrink at a faster pace and the trade deficit narrowed to its lowest level since 2010-11. The difficult international trade environment impacted the invisible transactions adversely with the result that earnings from invisibles (net) fell from $ 11.8 billion in 2014-15 to $ 10.8 billion in 2015-16. However, a sharper fall in the merchandise trade deficit enabled a narrowing of the CAD from 1.3 per cent of GDP in 2014-15 to 1.1 per cent of GDP in 2015-16. It is noteworthy that ***since 2013-14, CAD has remained well within the limits of external sustainability, aided by fall in gold imports and favourable terms of trade.***[9] Import cover of foreign exchange reserves was as high as 10.9 months in 2015-16 while foreign exchange reserves accumulation was $ 17.9 billion (down from $ 61.4 billion in 2014-15).

India's external sector showed resilience in 2016-17 amidst considerable flux in the international environment. Shrugging off a two-year contraction, exports turned around in the face of muted global demand. Merchandise imports remained sluggish with the result that India's merchandise trade deficit narrowed from $ 130.1 billion in 2015-16 to $ 112.4 billion in 2016-17. This helped in narrowing down the current account deficit from $ 22.1 billion in 2015-16 to $ 15.3 billion in 2016-17 (from 1.1 per cent of GDP in 2015-16 to 0.7 per cent of GDP in 2016-17). Net capital inflows were in excess of current account deficit leading to a reserve accumulation of $ 21.5 billion. The import cover of foreign exchange reserves improved further to 11.3 months. Current account deficit rose to as high as $48.7 billion in 2017-18. However, because of a substantial surplus of $92.3 billion on capital account, there was a reserve accumulation of $43.6 billion. Import cover of foreign exchange reserves was 10.9 months.

Reasons for Satisfactory Balance of Payments Situation in Post-Reform Period

As is clear from the discussion above, the balance of payments situation since 1991 has been quite satisfactory. ***Excepting the years 1995-96, 2008-09 and 2011-12, there has been substantial reserve accumulation over the period 1993-94 to 2017-18.*** The reasons for this satisfactory position are as follows:

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High Earnings from Invisibles. Table 37.2 brings out clearly the role played by invisibles in the balance of payments since 1991. As is clear from the Table, invisibles have all along contributed positive earnings since 1991 while there were always heavy deficits on trade account. The positive earnings from invisibles covered a substantial part of the trade deficit with the result that the current account deficit was reduced significantly. In 1993-94, the trade deficit was $ 4.06 billion while net earnings from invisibles were $ 2.90 billion. Thus, invisibles covered 71.4 per cent of the trade deficit. A little calculation on the data presented in Table 37.2 brings out that invisibles covered 62.8 per cent trade deficit in 1994-95, 73.7 per cent in 1999-2000 and 82.0 per cent in 2000-01. ***Earnings from invisibles exceeded the deficit on trade account in 2001-02, 2002-03 and 2003-04 with the result that there was a surplus on current account in these years.*** In 2016-17 and 2017-18, invisibles covered 87.4 per cent and 70 per cent of trade deficit respectively.

The impressive role played by invisibles in covering trade deficit is due to a sharp rise in invisible receipts *vis-à-vis* payments since 1992-93. The main contributing factors to rise in invisible receipts are non-factor services receipts and private transfers. As far as non-factor services receipts are concerned, the main development has been the rapid increase in the exports of software services. In fact, in a period of just fourteen years, 2003-04 to 2016-17, software service exports increased from $ 12.8 billion to $ 70.1 billion. As far as private transfers are concerned, their main constituent is workers' remittances from abroad. Over the period of ten years, 2004-05 to 2014-15, private transfers increased from $ 20.5 billion to $ 70 billion. ***With $ 68.9 billion, India was the largest recipient of private remittances in 2017 followed by China that got $ 64.0 billion.***

It is on account of the above reason that Shankar Acharya has argued that ***it is the surges in software exports and private remittances that are the main new contributors to improvement in the balance of payments situation in recent years.***[10]

Rise in External Commercial Borrowings. External commercial borrowings were used extensively in the latter half of 1980s to finance the current account deficit. In fact, in this period, external commercial borrowings accounted for more than 25 per cent of the total capital inflows into the economy. During some years in 1990s also, the dependence on external commercial borrowings has been quite high. For instance, of the total capital inflows (net) of $ 4,563 million in 1991-92, the share of external commercial borrowings was $ 1,456 million, *i.e.,* 31.9 per cent. Their share in 1995-96 was 42.9 per cent which rose further to 55.4 per cent in 1998-99 ($ 4,367 out of $ 7,867 million). However, during the years 2001-02 to 2003-04, external commercial borrowings were negative. External commercial borrowings rose to $ 22,610 million in 2007-08 but fell subsequently. They were $ 10,716 million in 2013-14 and only $ 232 million in 2014-15. External commercial borrowings were negative in 2015-16, 2016-17 and 2017-18.

Non-Resident Deposits. In addition to external commercial borrowings, the period of 1980s saw considerable increase in non-resident deposits also. This phenomenon continued right through the 1990s as well. In fact, the government has been offering various incentives to the non-resident Indians to bolster foreign exchange reserves of the country. As is clear from Table 37.3, non-resident deposits were $ 1,205 million in 1993-94 (which was 12.2 per cent of total capital inflows (net) in that year). The non-resident deposits rose to $ 2,978 million in 2002-03 and further to $ 3,642 million in 2003-04. However, ***there were***

Table 37.3

Inflows on Capital Account (Net) since 1991

(US $ million)

	1993-94	*1995-96*	*1996-97*	*2003-04*	*2007-08*	*2008-09*	*2015-16*	*2016-17*	*2017-18*
1. External assistance (net)	1901	884	1109	−2754	2111	2785	1966	2186	3011
2. Commercial borrowing (net)	608	1275	2848	−2928	22641	6647	−5856	−7590	−799
3. NR deposits (net)	1207	1104	3350	3643	179	4290	16052	−12367	9676
4. Foreign investment (net)	4233	4863	6154	15678	62000	27884	41264	49981	61595
5. Rupee debt service	−1054	−952	−727	−376	−121	−100	−77	−99	−75
5. Other flows (net)	2800	−2425	−1321	4076	21088	−33672	−13297	3857	18881
Capital Account (net)*	**9694**	**4690**	**11413**	**17338**	**107902**	**7835**	**40055**	**35967**	**92292**

* Difference in data of Table 37.2 and Table 37.3 is due to the item 'errors and omissions'. Errors and omissions for 2008-09, 2012-13, 2014-15, 2015-16 and 2016-17 were respectively $ 440 million, $ 2,689 million, −$ 1,021 million, −$ 1,073 million and $ 364 million. Adjusting for these for data given in Table 37.2, we get the figures for capital account (net) given in this Table.

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2008-09 (Mumbai, 2009), Table 142, pp. 237-41 and *Handbook of Statistics on Indian Economy* 2017-18 (Mumbai, 2018), Table 137, p. 212.

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net outflows from non-resident deposits in the year 2004-05 for the first time since 1990-91. In 2007-08, NRI deposits fell to only $ 179 million partly due to reduction in ceiling interest rates on various deposit schemes and large withdrawals from NRI deposits domestically. NRI deposits rose significantly to $ 38,892 million in 2013-14 in response to special incentives given by the Reserve Bank of India and stood at $ 16,052 million in 2015-16. However, there was a net outflow of $ 12,367 million from NRI deposits in 2016-17, following lumpy redemption of FCNR(B) deposits raised by banks during September to November 2013.[11] In 2017-18, NRI deposits was $ 9,676 million.

Role of Foreign Investment. Since 1991 the government has been offering various concessions, facilities and incentives to the foreign investors with a view to encouraging foreign investment into the country.[12] These measures have helped in increasing foreign investment substantially in recent years. In fact, in many years since 1991 the share of foreign investment was half or even more in total capital inflows (net) into the country.

Foreign investment is constituted of: (1) foreign direct investment, and (2) portfolio investment. Portfolio investment, in turn, consists of (*i*) foreign institutional investment and (*ii*) Euro equities and others (which include Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and offshore funds and others). In 2007-08, of the total foreign investment of $ 43,326 million, foreign direct investment (net) accounted for $ 15,893 million and portfolio investment for $ 27,433 million. Because of global recession in 2008-09, this year stands out as an exception as far as foreign investment is concerned. There was a large-scale withdrawal of resources by the foreign institutional investors and, as can be seen from Table 37.3, portfolio investment was – $ 14,030 million. Thus, although FDI (net) was $ 22,372 million, foreign investment (net) was only $ 8,342 million. However, foreign investment has increased considerably in recent years. In 2016-17 foreign investment was $ 49,981 million which rose further to $ 61,595 million in 2017-18. This has been due to India's robust economic performance, gloomy investment climate in the developed countries, and wide-ranging domestic reforms, in particular, easing of FDI norms.

THE MANAGEMENT OF BALANCE OF PAYMENTS

In this section we propose to discuss some important issues relating to the management of balance of payments. The issues are: (1) the linkages between fiscal and external policies, (2) issues relating to trade strategy, (3) exchange rate management, (4) issues pertaining to the capital account, (5) external debt, and (6) foreign currency reserves and reserve management strategy.

Linkages between Fiscal and External Policies

As noted by C. Rangarajan, ***imbalances in the external sector reflect the fundamental fact that aggregate absorption in the economy is in excess of the domestically produced goods and services***.[13] Accordingly, measures to reduce excess demand in the economy constitute an important policy ingredient of the adjustment towards creating a sustainable balance of payments environment. While excess absorption can originate either from the private or the public sector (or both), Rangarajan argues that, in reality, it is the fiscal deficit of the public sector is found to be associated with excess demand and the consequent deterioration of the current account balance. The link between the fiscal deficit and the current account balance can be derived from the following economy-wide financial balance identity:

Current Account Deficit = Income – (Consumption + Investment + Government Expenditure)
= Fiscal Deficit + (Private Saving – Investment Gap)

In symbols, we can write

$$X - M = Y - (C + I + G) = (T - G) + (S_p - I_p)$$

While this is merely an *ex post* identity, it does bring out an important policy issue. It explicitly shows that an improvement in the current account balance can be achieved either by an improvement in the balances of the public sector (T – G) and the private sector ($S_P - I_P$) combined, or by an increase in national income (Y) relative to domestic absorption (C + I + G).

In a situation of crisis, the identity implies that serious policy measures aimed at curtailing domestic absorption will be a necessary prerequisite for improving the external situation. As far as the medium term is concerned, the identity implies that a sustainable level of current account deficit is related to the relative rates of growth of income and absorption. Thus, "in any effort to maintain a reasonably comfortable level of current account deficit, domestic economic policy aimed at maintaining absorption at an appropriate level has an important role of play."[14] As far as the 'comfortable level of current account deficit' is concerned, Rangarajan feels that it should be no more than one per cent of the GDP.

Issues Relating to Trade Strategy

Trade strategies can be broadly divided into two groups, outward-oriented and inward-oriented. ***An outward-oriented strategy is one in which trade and industrial policies do not discriminate between production for the domestic goods and foreign goods. As against this, inward-oriented strategy is one in which trade and industrial***

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incentives are biased in favour of production for the domestic market over the export market. While outward-oriented strategy is often designated as the export promotion strategy, inward-oriented strategy is designated as the import substitution strategy.[15] The general instruments of an inward-oriented strategy are commercial policy, industrial policy, and exchange rate policy. The inward-oriented regimes are characterised by high levels of protection for manufacturing, direct controls on imports and investments, and overvalued exchange rates. As against this, outward orientation links the domestic economy to the world economy. The discriminatory use of tariffs, quotas, investment licensing, tax and credit subsidies, and so on, is incompatible with the purest form of outward oriented strategy.

Import Substitution Policy in India: Constraints to Growth. ***India opted for a strongly inward-oriented strategy in the early decades of economic planning. The basic rationale for adopting this strategy was that it would help rapid industrialisation through import substitution and at the same time save valuable foreign exchange.*** The policy succeeded in achieving both these objectives to a considerable degree. However, a number of studies conducted all over the world have shown that outward-oriented policies have performed better while inward-oriented policies have constrained growth. For instance, the *World Development Report* (1987) studied data for 41 countries over the period 1963 to 1985 to examine the links between trade strategy and economic performance. These countries were divided into four categories — strongly outward-oriented, moderately outward-oriented, strongly inward-oriented, and moderately inward-oriented. Hong Kong, Korea and Singapore fell in the group of strongly outward-oriented countries while India (alongwith some other countries) fell in the group of strongly inward-oriented countries. The study revealed that outward-oriented economies performed distinctly better than the inward-oriented economies in almost all respects. For instance, while the strongly outward-oriented economies achieved a 7.7 per cent per annum growth rate of GDP in the period 1973-85, the strongly inward-oriented economies could manage a growth rate of only 2.5 per cent per annum during the period. Similar tendencies were observed in the case of other crucial indicators of development also like trends in per capita income, gross saving rate, incremental capital-output ratio, development of the manufacturing sector, price stability, growth of manufactured exports, etc. As far as the growth of manufacturing sector is concerned, average annual growth of manufacturing value added was 10.0 per cent in strongly outward-oriented economies during 1973-85 but only 3.1 per cent in strongly inward oriented economies.

According to the WDR, the main advantage of the outward-oriented strategy over the inward-oriented strategy is that it promotes the efficient use of resources. As against industries under inward-oriented strategy (which are provided protection and sheltered home market), industries under outward-oriented strategy face greater competition and therefore try to utilise their resources in the best possible way. Not only this, in a bid to improve or maintain their market position, the exporting firms need to keep up with modern technology and bring managerial skills up to international standards. These firms also benefit from a considerable transfer of technology from abroad. Data presented by the *WDR* on productivity growth in developing countries show that total factor productivity increased much faster in the strongly outward-oriented economies than in the strongly inward-oriented economies.

As against the above, ***inward-oriented strategy (i.e., the import substitution strategy) leads to high levels of effective protection. The currency becomes over valued and exports are discouraged.*** Under this strategy, relatively capital intensive and intermediate input intensive techniques of production are encouraged. High capital intensity leads to under utilisation of capacity and slow growth in industrial employment. Despite low capacity utilisation, high protection ensures high profitability in domestic markets. This acts as a disincentive to export. Trade interventions encourage resource misallocation while excessive government intervention leads to corruption, uncertainty and delays.

Trade Policy Options for India. The message of the above discussion is clear enough — India should go in for globalisation and open up its economy considerably by liberalising the import-export regime. This would imply the conversion of quantitative restrictions to low and uniform tariffs, and the use of the exchange rate (rather than quantitative restrictions or tariffs) for bringing about balance of payments equilibrium.[16] There is a strong support for this policy among many economists and international financial institutions. In fact, the policy package offered by the World Bank and IMF to the developing countries facing balance of payments problems in the 1980s, specifically included import liberalisation and a more 'open' trade and industrial policy as a condition for the grant of assistance. However, as in now well documented, several structural adjustment programmes (implying massive import liberalisation) introduced by the developing countries at the behest of the World Bank and the IMF have run into trouble. The reasons are not far to seek. While liberalisation of imports pushed up the import bill immediately, the export sector failed to respond at such a fast pace. This is due to the reason that favourable impact on exports can occur only after some time when resources have moved from

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non-tradeable to tradeable sectors. Therefore the deficits actually increased. It is thus obvious that such a programme can be undertaken only if adequate financing for a sufficiently long period is available. Even in countries like Japan, Korea and Taiwan which are the leading success stories of outward-oriented strategy, import liberalisation was not done suddenly. In all these countries, the post-War period began with an initial phase of macroeconomic instability, followed by several years of stabilisation and import substituting growth and eventually by a turn to export led growth in the early 1960s.

Much more positive action is needed on the export front. In this context, Bimal Jalan has advocated the following measures: (*i*) further reductions in tariff rates to international levels in order to remove the remaining bias against production for exports; (*ii*) allowing exporters to borrow abroad at international rates as domestic interest rates are substantially higher (which increase the cost of production and lower the expected returns from investments); (*iii*) creating special domestic financing facilities in term-lending institutions for export-related investments in a bid to insulate the exporters from high domestic interest rates; (*iv*) providing adequate and improved infrastructure for exporters; and (*v*) aggressive State intervention to promote exports (as is being done by most other countries, including industrial countries like Japan and USA). Such intervention should be strategic and should be directed at improving the domestic environment for exports and opening markets abroad. According to Jalan, while India has intervened heavily to promote exports in the past, the 'quality' of such intervention has been poor as compared with the policies pursued by successful exporters like Japan, Korea, Malaysia and China. "Unlike India, their intervention was strategic and not detailed. They encouraged competition in the domestic market; India fragmented its markets. India concentrated on identifying products and providing specific amounts of assistance on a case-by-case basis. The Japanese or the Korean system, on the other hand, was concerned with altering the generalised incentive framework in favour of exports rather than with specific products and specific markets."[17]

Exchange Rate Management

Exchange rate management plays a role complementary to trade policy. This is on account of the fact that exchange rate movements can be used for correcting the imbalances in the current account of the balance of payments. In India, prior to 1991, the rupee was pegged to the US dollar, pound sterling or a basket of currencies of India's major trading partners. In July 1991 when the Government of India announced major trade and industrial policy liberalisation measures, a two-step downward adjustment of 18-19 per cent was carried out in the exchange rate of the Indian rupee. This was expected to help the country in increasing the export earnings and thus in tackling the serious imbalances in the balance of payments. On the basis of the Report of the High Level Committee on Balance of Payments chaired by C. Rangarajan, the government introduced partial convertibility of rupee in 1992-93 Budget known as liberalised exchange rate management system (LERMS). This was followed by market-determined exchange rate regime in 1993. ***The exchange rate is now largely determined by the market, i.e., demand and supply conditions. However, Reserve Bank intervenes to check excessive volatility in the market. Such an exchange rate regime is known as the 'managed float' regime.*** "The objective of exchange rate management has been to ensure that the external value of the rupee is realistic and credible as evidenced by a sustainable current account deficit and manageable foreign exchange situation. Subject to this predominant objective, the exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilising speculative activities, help maintain adequate level of reserves, and develop an orderly foreign exchange market."[18]

Issues Pertaining to the Capital Account

In his article cited earlier, C. Rangarajan discusses three issues pertaining to the capital account: (1) external commercial borrowings, (2) NRI deposits, and (3) short-term debt.[19]

1. External Commercial Borrowings. Before 1980s almost the entire deficit in current account was financed by concessional assistance. However, in 1980s (particularly in the latter half of 1980s), dependence on external commercial borrowings increased significantly due to increasing shortage of concessional assistance. During 1990s also, the dependence of the country on external commercial borrowings was quite high. ***Since external commercial borrowings are obtained at high rates of interest, the dependence on high cost methods of financing increased.*** This represented a substantial future liability as too much dependence on external commercial borrowing can put extreme pressure on future generations unless the use of resources obtained through external commercial borrowings is highly productive and generates handsome foreign exchange earnings.

2. Non-Resident Deposits. During 1985-90, non-resident deposits accounted for 23 per cent of the financing need. In a large measure, the inflow of funds under these deposits was a response to conscious policy incentives in the forms of attractive interest rate differentials, exchange risk guarantees to banks and fiscal concessions.[20] However, just like external commercial borrowings, NRI deposits are also a high cost method of raising funds. Moreover, just like foreign institutional investors, the objective of non-residents is also to maximise returns. If conditions turn unfavourable,

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they are likely to withdraw funds from the country. Thus, ***both foreign institutional investors and non-residents are 'fair weather' friends.***

3. Short-term Debt. At times, countries resort to short term debt to bridge the balance of payments deficit. For instance, in India, short-term debt constituted 10 per cent of total external debt at end-March 1990. However, ***this money is frequently 'hot money' which moves across countries in search of high returns.*** Accordingly, too much dependence on such debt is a highly risky proposition and can land the country in serious problem if there is a sudden withdrawal. On account of this reason, the Government of India tried to reduce its dependence on short-term debt with the result that short-term debt, as a proportion of total external debt, came down to 4.0 per cent at end-March 2000 and further to only 2.8 per cent at end-March 2002. However, what is a matter of concern is the fact that dependence on short-term debt has increased significantly in recent years. It was as high as 23.9 per cent of total external debt at end-March 2013 (i.e., almost one-fourth) and stood at 19.3 per cent of total external debt at end-March 2018.

External Debt

A country's external indebtedness is a 'mirror image' of the behaviour of the current account in the balance of payments. In this sense, ***the outstanding volume of India's external debt represents the accumulation of deficits in the current account over the past years.***[21] India's external debt was $ 83.8 billion at end-March 1991 which rose to $ 529.7 billion at end-March 2018. According to World Bank, India is the ***third*** most indebted country among developing countries in terms of stock of external debt after China and Brazil.[22]

Foreign Currency Reserves and Reserve Management Strategy

The payment crisis of 1991-92 underscored the acute problem of liquidity and international confidence that arise when foreign exchange reserves are depleted to finance overall deficits in the balance of payments. Accordingly, the Reserve Bank of India has attempted to build up adequate stocks of foreign exchange reserves to meet any contingencies arising out of the size of the current account deficit, short-term liabilities, the possible variability in portfolio investments and other type of capital flows, the unanticipated pressures on the balance of payments arising out of external shocks, movements in repatriable foreign currency deposits of non-resident Indians etc. It is now also realised that a sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the liquidity at risk on all accounts over a fairly long period.[23]

The level of foreign exchange reserves increased considerably from US $ 5.8 billion at end-March 1991 to $ 97.6 billion at end-December 2003 and further to $ 309.7 billion as at end-March 2008. The traditional measure of trade based indicator of reserve adequacy, *i.e.*, the import cover which shrank to three weeks of imports by the end of December 1990 also improved significantly to 14.4 months in 2007-08. The foreign exchange position improved considerably on all other norms of adequacy as well. For instance, the ratio of foreign exchange reserves to external debt rose from 7.0 per cent in 1990-91 to 72 per cent in 2002-03 and further to 138 per cent at end-March 2008. Thus, ***the foreign exchange reserves exceeded the external debt at end-March 2008*** (by as much as $ 85.3 billion). However, because of global recession in 2008-09 and capital outflows, the foreign exchange reserves fell subsequently. Foreign exchange reserves stood at $ 370 billion at end-March 2017. The import cover of foreign exchange reserves was 8.9 months in 2014-15 which rose to 11.3 months in 2016-17.

CHALLENGES AND OUTLOOK

A trade deficit of more than 8 per cent of GDP and CAD of more than 3.0 per cent is a sign of growing imbalance in the country's balance of payments. From this point of view, the situation turned grim in 2011-12 and 2012-13. As stated earlier, the main reason behind the increasing trade deficit was the high and rising expenditure on imports of gold and petroleum. Despite net positive earnings from invisibles of $ 111.6 billion in 2011-12 and $ 107.5 billion in 2012-13, ***CAD rose to as high as 4.3 per cent of GDP in 2011-12 and 4.8 per cent of GDP in 2012-13.*** This was a matter of serious concern as it implied heavy dependence on capital inflows (and, in turn, on foreign investors) to close the gap. Accordingly, the government and RBI undertook various 'crisis management measures'. These measures worked quite effectively and as is clear from Table 37.1, CAD declined swiftly from its peak of 4.8 per cent GDP in 2012-13 to 1.3 per cent in 2014-15 and further to 0.6 per cent in 2016-17. However, there are some points of concern:

1. The entire downward adjustment in CAD between 2012-13 and 2016-17 is attributable to ***import compression*** of 10.2 per cent of GDP, from 27.5 per cent of GDP in 2012-13 to 17.3 per cent in 2016-17, mostly due to gold import restrictions, the slowdown of GDP growth and, since summer 2014, the collapse in oil and other commodity prices.

2. What is striking is that none of the CAD adjustment in attributable to an improvement in the exports/GDP ratio. Indeed, the ratio fell from 16.8 per cent of GDP in 2012-13 to 12.3 per cent in 2016-17. This is in sharp contrast

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with the export trajectory recorded after the full-fledged BOP crisis in 1991-92. At that time, annual export growth had recovered quickly to exceed 20 per cent by 1993-94, two years after the crisis, and kept on growing at close to that rate for another two years.

3. In the last three years, there has been no improvement in the ratio of 'net invisibles' to GDP. It has, in fact, declined from 6.2 per cent of GDP in 2013-14 to 5.2 per cent in 2015-16 and further to 4.3 per cent of GDP in 2016-17 and is substantially below the peak of 7.5 per cent attained in 2008-09. As ratios to GDP, the key invisibles categories of software exports and private remittances from abroad have stagnated or declined marginally.

4. With the impressive reduction of CAD being solely due to import compression, its future sustainability remains subject to vagaries of international oil and other commodity (including gold) prices and the import intensity of any long-sought revival of industrial growth. Further, India's IT sector could face a challenging business environment from policy changes in the US which can affect its export potential.[24]

On account of the above reasons, critics argue that the pattern of current account adjustment observed in the recent past provides limited comfort for the medium-term sustainability of our external finances, and therefore, regard the current level of complacency regarding our macro-balances as 'unjustified'.[25]

How Much CAD is Sustainable? The high levels of CAD recorded in recent years have once again sparked the debate on the sustainable level of CAD. The Rangarajan Committee on Balance of Payments (1993) regarded 2 per cent of GDP as a sustainable level of CAD. However, as pointed by Y.V. Reddy, the Committee did not make a distinction between a ceiling and an average.[26] In fact, 2 per cent was treated as an average since the reforms process began, though the actual deficit in high growth years was close to 1 per cent. Subsequently, in fact more recently, the view in the government circles and RBI is that a range of 2.5 to 3.0 per cent CAD is manageable. The Twelfth Five Year Plan assumed 2.5 per cent current account deficit per annum as one of the means of financing the investments over the Plan period. As noted by Y.V. Reddy, if one is planning on a 2.5 per cent deficit on an average, then in the years when one is subjected to shock, it could become 4 per cent to 5 per cent.[27] The international financial markets may not tolerate that level. If this presumption is true, notes Reddy, ***"one has to target current account deficit at zero or close to it so that it provides headroom in any year to absorb the shocks."***[28] A zero current account deficit does not mean that the current account as a proportion of GDP should be smaller. In fact, the current account deficit can be larger as is happening in many East Asian economies. The exports and imports may be larger, but the deficit will have to be close to zero, on an average, over the medium term.

NOTES

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20. *Ibid.*, p. 210.
21. *Ibid.*, p. 212.
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40 Chapter

INDIA'S EXCHANGE RATE POLICY, FOREIGN EXCHANGE RESERVES AND CAPITAL ACCOUNT CONVERTIBILITY

In the fast changing international trade scenario marked by increasing globalisation and trade 'openness' in recent years, exchange rate policy has emerged as a key policy variable. With rapidly increasing integration of global financial markets and increased capital mobility across the world, exposure to exchange rate risks has also increased. As the Mexican crisis in 1992, East Asian meltdown in 1997, Russian crisis in 1998 and the experience of Argentina in 2002 have clearly shown, exchange rate changes can play havoc with the economies. Accordingly, economists have shown a renewed interest in issues relating to exchange rate regime, and a large body of theoretical and empirical literature on the subject has emerged. Economists are once again debating which exchange rate regime is the best and how should exchange rates be managed. In India, capital account liberalisation has also emerged as an important issue of debate.

In this chapter, we shall discuss:

- Choice of exchange rate regime, *i.e.,* the choice between fixed, flexible and intermediate exchange rate regimes
- Exchange rate management in India
- Foreign exchange reserves in India
- The issue of capital account convertibility

CHOICE OF EXCHANGE RATE REGIME

The two polar (or extreme) cases of exchange rate regimes are: (i) the fixed exchange rate regime, and (ii) the fully floating (or market-determined) exchange rate regime. Between these two extremes, one can think of a number of intermediate regimes which combine the important features of these two regimes in different ways. The supporters of the fixed exchange rate regime argue that it provides credibility, transparency, very low inflation and financial stability. Countries for which pegged exchange rates seem to be appropriate are small economies with a dominant trading partner that maintains a reasonably stable monetary policy.[1] The international experience also reveals that a large number of small economies have pegged their exchange rate regimes. For instance, small Caribbean island economies, some small Central American countries and some Pacific island economies peg to the US dollar. African countries like Lesotho, Namibia and Swaziland peg to the South African Rand. Countries like Nepal and Bhutan peg their currency to the Indian rupee.

The other extreme is the fully floating exchange rate regime. In this case, there is no government (or central bank) intervention and the currency's value is determined by the free play of demand and supply forces. The chief merit of flexible or floating exchange rate is the simplicity of its operative mechanism. The supporters of this exchange rate regime argue that it is much easier to change one price, namely the exchange rate, than to alter thousands or millions of individual prices, when an economy needs to enhance (or reduce) its international price competitiveness in the interest of balance of payments adjustment. In the new international trading environment in which the entire emphasis is on 'opening up' all trade and restrictions of any kind are being frowned upon, there is an increasing pressure on the developing countries to adopt a fully floating exchange rate regime. However, most of these countries have resisted these pressures as free float carries the risk of volatility which could unsettle the entire external sector of these economies via speculative market activities and large-scale capital outflows and can thus have disastrous effects on the domestic sector as well.

Between the two extremes of 'hard pegs' and 'full float', there is a large spectrum of exchange rate systems that combine features of these two regimes in various degrees. All of them can be conveniently clubbed into, what can be called, 'intermediate exchange rate regimes.' For a substantially long period of time, many countries followed a 'fixed but adjustable' exchange rate regime in which countries pegged their nominal exchange rates but altered them through devaluation if such an action was needed. Some countries opted for a tight band, some for crawling peg and some others for crawling band. ***Most countries in the present-day world are following intermediate regimes***

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with country-specific features, no targets for the level of the exchange rate, and exchange market interventions to ensure orderly exchange rate movements. While the increasingly accepted view is that exchange rates should be flexible and not fixed or pegged, it is also emphasised that countries should be able to intervene or manage exchange rates if movements are believed to be destabilising in the short run.

Tarapore Committee on Fuller Capital Account Convertibility which submitted its Report on July 31, 2006 envisages an exchange rate policy for India aimed at maintaining the real effective exchange rate broadly within a +/-5 per cent band around a neutral level. This is essentially a plea for ***'managed floating.'*** According to A.V. Rajwade, in the context of developing economies today, this seems to be a rational policy on account of, at least, the following two arguments:[2] ***Firstly***, today's developed economies have never grown in their history as fast as several of the Asian economies have done, the most important example being of course China over the last quarter century. There is no comparable record of hundreds of million of people coming above the poverty line in just one generation. And, the exchange rate policies have been an important element of the macroeconomic policy spectrum which enabled this. ***Secondly***, most of the exports of the developing countries are of 'manufactured commodities' which are extremely sensitive to cost and pricing. Since exchange rate is an important factor in determining the price competitiveness in international markets, it plays an important role in determining the economic competitiveness of a developing country. It is indeed true that central bank intervention and sterilisation[3] of money supply can have financial costs. However, the costs to the real economy of misaligned exchange rates (which are quite possible in the case of a fully floating exchange rate regime), in terms of lost growth and jobs, can be far greater.

EXCHANGE RATE MANAGEMENT IN INDIA

Over the last six-and-a-half decades since Independence, the exchange rate system in India has transited from a fixed exchange rate regime where the Indian rupee was pegged to the pound sterling on account of historic links with Britain to a basket-peg during the 1970s and 1980s and eventually to the present form of market-determined exchange rate regime since March 1993.

Par Value System (1947-1971)

After gaining Independence, India followed the par value system of the IMF whereby the rupee's external par value was fixed at 4.15 grains of fine gold. In terms of currencies, the exchange rate was pegged to pound sterling at ₹ 13.33 per pound sterling (or ₹ 4.76 per US dollar) in September 1949. This remained unchanged upto June 1966 when the rupee was devalued by 36.5 per cent to ₹ 21 per pound sterling (or 1 US $ = ₹ 7.50). This exchange rate of the rupee remained constant till 1971 when the Bretton Woods system collapsed with the suspension of convertibility of the dollar by the USA.

Pegged Regime (1971-1992)

India pegged its currency to the US dollar (from August 1971 to December 1991) and to the pound sterling (from December 1971 to September 1975). Following the breakdown of the Bretton Woods system, there was downward pressure on the pound sterling *vis-à-vis* major international currencies; being pegged to the sterling, this led to misalignment of the rupee *vis-à-vis* other currencies. Moreover, the importance of UK in India's trade had declined over the years. To overcome the weaknesses associated with a single currency peg, the Indian rupee, effective September 1975, was delinked from the pound and pegged to a basket of currencies of India's major trading partners. This system remained in vogue till 1992. ***During this period, i.e., 1975 to 1992, the exchange rate of rupee was officially determined by the Reserve Bank of India within a nominal band of +/–5 per cent of the weighted basket of currencies of India's major trading partners.***

By the late 1980s and the early 1990s, it was recognised that both macroeconomic policy and structural factors had contributed to a misalignment in the exchange rate. Devaluation by many of India's competitors (despite their lower inflation than in India) had aggravated the misalignment. For instance, China and Indonesia depreciated their currency against the US dollar more than India, despite lower inflation, over the period end-December 1980 to end-December 1989. As a result, India's export competitiveness suffered a setback. In fact, ***Suresh Tendulkar has alleged that the period from 1947 to 1993 was one in which, except for occasional and dramatic episodes of devaluation (as in 1949 and 1966), there was no active use of changes in the nominal exchange rate as a tool of macroeconomic management.*** Indeed, for most of this period, the exchange rate was overvalued. This overvalued exchange rate provided cheap foreign exchange for priority uses (particularly by the government), discriminated against exports, and generated excess demand for imports restricted by quantitative restrictions. According to Tendulkar, the absence of correction for exchange rate overvaluation and its bias against exports led to an export stagnation while boosting demand for imports. "The options of exchange rate adjustment and the aggressive use of trade policies to promote exports were not seriously considered."[4]

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The Period Since 1991

A two-step downward adjustment of 18-19 per cent in the exchange rate of the Indian rupee was made on July 1 and 3, 1991 with a view to placing it at an appropriate level in line with the inflation differential with major trading partners in an effort to maintain the competitiveness of exports. This provided the necessary impetus for allowing greater exchange rate flexibility. It was felt that small and frequent changes in the exchange rate that would be signalled by market forces would be a better alternative to large and delayed corrections necessitated by a basket-pegged regime. The transition to a market based system was sequenced on the basis of the Report of the High Level Committee on Balance of Payments chaired by C. Rangarajan. The first step in this transition was the introduction of partial convertibility of rupee in 1992-93 Budget known as liberalised exchange rate management system (LERMS). This was followed by market-determined exchange rate regime in 1993.

Liberalised Exchange Rate Management System. The Finance Minister announced the liberalised exchange rate management system (LERMS) in the Budget for 1992-93. This system introduced partial convertibility of rupee. Under this system, a dual exchange rate was fixed under which 40 per cent of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60 per cent were to be converted at a market-determined rate. The foreign exchange surrendered at official rate was to be used for the import of essential items (like crude oil, petroleum products, fertilisers, life-saving drugs, etc.) and the foreign exchange converted at the market price was to be used to finance all other imports. Since the official exchange rate was lower than the market rate, this system meant taxing the exporters to subsidise the government's bulk imports. The implicit export tax was between 8-12 per cent and was highly resented by exporters.

Market-determined Exchange Rate Regime (1993 to Present Day). The LERMS was essentially a transitional mechanism and provided a fair degree of stability. There was also a healthy build-up of reserves. As a result, ***there was a smooth changeover to a regime under which the exchange rates were unified effective March 1, 1993. Since then, the day-to-day movements in exchange rates have been largely market-determined.*** "The objective of exchange rate management has been to ensure that the external value of the rupee is realistic and credible as evidenced by a sustainable current account deficit and manageable foreign exchange situation. Subject to this predominant objective, the exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilising activities, help maintain adequate level of reserves, and develop an orderly foreign exchange market."[5] This shows that the market-determined exchange rate regime being followed by India since 1993 is a 'managed float' regime.

Under the unified exchange rate regime adopted in the 1993-94 Budget, the 60:40 ratio was extended to 100 per cent conversion. This 100 per cent conversion was extended for: (*i*) almost the entire merchandise trade transactions (*i.e.,* export and import of goods); and (*ii*) all receipts, whether on current or capital account of balance of payments, but not all payments. Side-by-side, the official RBI rate also stayed on for the conversion of items not permitted under the unified market rate, *i.e.,* more than half a dozen of invisible items of current account as well as capital account. In addition, various exchange control norms of the Reserve Bank remained in operation all along, albeit with some relaxation of provisions. This shows that the 1993-94 Budget introduced full convertibility on trade account. In February 1994, the Reserve Bank undertook several steps towards achieving current account convertibility[6] when it announced relaxations in payment restrictions for a number of invisible transactions and liberalisation of exchange control regulations upto a specified limit relating to: (*a*) Exchange Earners' Foreign Currency (EEFC) Accounts; (*b*) basic travel quota; (*c*) studies abroad; (*d*) gift remittances; (*e*) donations; and (*f*) payments of certain services rendered by foreign parties. Current account convertibility was finally achieved in August 1994 when the Reserve Bank further liberalised payments and accepted obligations under Article VIII of the IMF, under which India is committed to foresake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments.

The experience with the market-determined exchange rate system has been satisfactory. For most of the period since 1993, the foreign exchange market was characterised by orderly conditions, excepting a few episodes of volatility. The nominal exchange rate of the rupee *vis-à-vis* the US dollar was around ₹ 31.37 per dollar over the period March 1993 to August 1995. The average exchange rate for the five year period 2003-04 to 2007-08 was ₹ 43.1 per dollar and it depreciated to an average of ₹ 51.1 per US dollar over the five year period 2009-10 to 2013-14.[7] The exchange rate of the rupee was ₹ 64.81 per dollar at end-March 2017 and ₹ 65.18 per dollar at end-March 2018.

THE MANAGEMENT OF FOREIGN EXCHANGE RESERVES

Foreign Exchange Reserves: Rationale for Accumulation and the Question of Adequacy

Under the Bretton Woods system, foreign exchange reserves were used by the monetary authorities mainly to

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maintain the external value of their respective currencies at a fixed level. After the breakdown of the Bretton Woods system in the early 1970s, countries started adopting flexible exchange rate regimes. Under a perfectly flexible exchange rate regime, foreign exchange reserves play only a marginal role. However, as noted earlier, most of the countries adopted 'intermediate' exchange rate regimes which require intervention by central banks in the foreign exchange market from time to time. Therefore, holding of adequate foreign exchange reserves becomes imperative. ***The need for maintaining adequate foreign exchange reserves has increased over time with the acceleration in the pace of globalisation and enlargement of cross-border capital flows which are highly volatile in nature.*** The main objectives of holding reserves can be stated as follows: (*i*) maintaining confidence in monetary and exchange rate policies; (*ii*) enhancing the capacity to intervene in foreign exchange markets; (*iii*) limiting external vulnerability so as to absorb shocks during times of crisis; (*iv*) providing confidence to the markets that external obligations can always be met; and (*v*) reducing volatility in foreign exchange markets.[8]

The question that needs to be addressed here is: what is the appropriate size of reserve holdings for a country to meet the above objectives? ***The size depends on the following five key factors — size of the economy, current account vulnerability, capital account vulnerability, exchange rate flexibility and opportunity costs.***

As far as the practical approach to the determination of reserve adequacy is concerned, traditionally the adequacy was determined by a simple rule of thumb: i.e., the stock of reserves should be equivalent to a few months of imports. However, the financial crises in the 1990s highlighted the limitations of this approach. It is now being increasingly recognised that focussing only on current account transactions is insufficient as it is the capital account transactions that are now more important. Among various components of capital account transactions, short-term external debt has gained prominence in determining reserve adequacy. From the perspective of crisis prevention, reserves to short-term debt ratio has emerged as a benchmark to determine the adequacy of reserves. It has been suggested that empirical assessment of reserve adequacy should be so defined that the country can meet its external repayment obligations without additional borrowing for one year – the so-called Guidotti Rule (proposed by Pablo E. Guidotti in 1999).

India's Approach to Reserve Management

According to the Reserve Bank, India's approach to reserve management during the post-1991 period has mirrored the changing composition of balance of payments and has endeavoured to reflect the 'liquidity risks' associated with different types of flows and other requirements. The policy for reserve management is built upon a host of identifiable factors and other contingencies, including, *inter alia*, the size of the current account deficit and short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investments and other type of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movements in repatriable foreign currency deposits of non-resident Indians. ***A sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the 'liquidity of risk' on all accounts over a fairly long period.***

During recent period, the strong build-up of reserves has been associated with the Reserve Bank's attempt to prevent the rupee from appreciating too fast. Because of the rush of capital inflows from various sources, the Indian economy has been flooded with dollars. These dollars are not being adequately absorbed in the economy because of sluggish imports and capital controls. The swelling tide of dollars has lifted the rupee substantially. This has the authorities worried as they feel that a strong rupee would adversely affect the competitiveness of Indian exporters severely. So, the Reserve Bank has intervened excessively in the foreign exchange market from time to time to prevent rupee from appreciating too fast. With this end in view, it bought dollars from the market and sold rupees in return. The dollars that were thus purchased added to the foreign exchange reserves of the country. Thus, the rising foreign exchange reserves are closely linked to the exchange rate management policy of the Reserve Bank of India. The extra rupees that have been released into the economy as a consequence of this policy have a potential of creating inflationary pressures in the economy or they can create ripples in the stock, bond and real estate markets. To avoid this possibility, the Reserve Bank has been selling some of the government securities it holds to suck out the rupees it has released in the economy. ***This entire process — purchasing dollars, releasing rupees and then sucking them out through sales of government securities — is called 'sterilisation' (or sterilised intervention).*** This has been the cornerstone of Reserve Bank's policy over the last few years. However, critics argue that this policy has now reached its limits as the amount of marketable government securities with the Reserve Bank has considerably shrunk.

India's Foreign Exchange Reserves

India's foreign exchange reserves have increased considerably in the post-1991 period – from US $ 5.8 billion at end-March 1991 to $ 370.0 billion at end-March 2017.

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While foreign exchange reserves at end-March 1991 were enough to cover imports of just about ten days, they were enough to cover as much as 10.9 months of imports in 2015-16. Alongwith an improvement in the import cover, other indicators on the adequacy of reserves have also improved. For instance, the ratio of foreign exchange reserves to external debt rose from 7.0 per cent as at end-March 1991 to 138 per cent in 2007-08 and stood at 78.4 per cent as at end-March 2017. ***The ratio of reserves to short-term debt rose from 68.3 per cent as at end-March 1991 to 420 per cent as at end-March 2017.***

However, in this context, it is necessary to consider the following points:

1. A substantial part of the build-up of foreign exchange reserves since 1991 has been due to NRI deposits and foreign institutional investor (FII) investments. As correctly pointed out by C.P. Chandrasekhar, ***these kinds of investments rarely, if ever at all, finance new investments in the domestic economy. These are also typical inflows that would be reversed in case of any sign of uncertainty leading to fast erosion of foreign exchange reserves.***[9]

2. The Reserve Bank has been claiming that reserve accumulation in recent years has been due to higher remittances, quicker repatriation of export proceeds and non-debt inflows. In other words, the rise in foreign exchange reserves is driven by 'fundamental factors' and is not a response to 'arbitrage' motives. However, ***large NRI deposits and FII investments suggest that arbitrage has played an important role in building up foreign exchange reserves.*** Arbitrage is being done by NRIs, corporate treasuries through short-term external commercial borrowings that are invested in India, foreign institutional investors who are investing in Indian debt and banks which are bringing in short-term capital. These are all being driven by: (*i*) the difference between domestic and international rates; and (*ii*) the expectation that the rupee would remain stable or appreciate further. The problem with arbitrage flows is that they are, by their very nature, fickle. ***A rise in international interest rates (which could be caused by a decline in global liquidity) or a rise in the dollar's value can squeeze the arbitrage window leading, in turn, to a reversal of flows.***

3. As correctly pointed out by Jayati Ghosh, while the recent increase in inflows represents the fact that India now seems to be a better destination to foreign investors *vis-à-vis* other developing countries, the fact that it is merely translating into a build-up of foreign exchange reserves is worrisome, because it means that such inflows are not contributing to increased investment within the economy. Excess foreign currency holdings reflect an excess of *ex ante* savings over *ex ante* investment and suggest an economy operating well below potential, and an enormous slack in terms of the use of resources.[10]

THE ISSUE OF CAPITAL ACCOUNT CONVERTIBILITY

The Case For and Against Capital Account Convertibility

Capital account liberalisation has been viewed by many economists as an important component of the overall opening up of global trade and financial markets. Therefore, alongwith removal of restrictions on merchandise trade and current account convertibility, they have advocated full capital account convertibility as well. The arguments put forward in favour of full capital account convertibility are as follows:

1. Liberal capital account leads to faster economic growth.

2. Developing countries need external capital to sustain an excess of investment over domestic saving and an open capital account can attract foreign capital. It is also argued that such capital flows can have favourable 'spillover' effects also in the form of technology, skills, and introduction of new products as well as positive externalities in terms of higher efficiency of domestic financial markets resulting in improved resource allocation and efficient financial intermediation by domestic financial institutions.

3. Since effective implementation of capital controls becomes more and more difficult in a globalised economy, this *de facto* situation should be recognised *de jure* by lifting controls on capital account transactions.

4. Full capital account convertibility will force governments to behave more responsibly on fiscal balances. Unsustainable deficits would frighten investors, leading to capital flight from the country — and this danger would force governments to act more responsibly in controlling fiscal deficits.

However, none of these arguments stands to close scrutiny. As far as the first argument is concerned, A.V. Rajwade has pointed out that ***there is no conclusive evidence to suggest that a liberal capital account leads to faster economic growth.*** On the other hand, there are clear risks in liberalising the capital account. Therefore, for judging the desirability or otherwise of capital account convertibility, one must carefully weigh the 'risks' as against the 'rewards'. While rewards are uncertain, risks are very obvious as a liberal capital account can amplify and prolong a crisis.

As far as the second argument is concerned, Rajwade argues that there is no necessary link between increased capital inflows and full convertibility on capital account —

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China has attracted huge capital inflows without the currency being convertible even on the current account. This shows that from the point of view of the foreign investor ***what matters is the economic and industrial performance of the country and not capital account convertibility.***

The third argument is a 'non-argument' — one cannot justify (or legalise) a wrong just because it exists. For example, one knows that there is widespread corruption in India. Similarly, there are thefts and robberies and other crimes in violation of the laws. "Can this be an argument for legalising corruption or theft"?[11] Obviously no.

As far as the argument that full capital account convertibility will force the governments to act more responsibly on the fiscal front is concerned, Rajwade points out that such optimism is not borne out by empirical evidence. Moreover, in a democratic country, it is for the citizens to discipline the political masters and they should not depend on a hundred odd currency and bond dealers, focussed on short-term trading profits, to do so at an enormous cost to the real economy.

As the above discussion shows, the arguments in favour of full capital account convertibility do not stand a close scrutiny. On the other hand, the case against full capital account convertibility is quite strong. This rests on the various risks associated with capital account liberalisation like potential macroeconomic instability arising from the volatility of short-term capital movements; the risk of large capital outflows and associated negative externalities; export of domestic savings from capital scarce developing countries; and weakening the ability of authorities to tax domestic financial activities. The experience of Mexico in 1994, East Asian countries in 1997, Russia in 1998, Brazil in 1998-99 and Argentina in 2001 has highlighted the risk of capital account liberalisation. For instance, the East Asian countries had undertaken several steps in 1980s and 1990s to open up their capital accounts and had removed most of the restrictions on their financial markets. These steps led to massive capital inflows in these countries. ***A major part of these inflows were in the form of 'hot money'[12] which were extremely vulnerable to expectations and speculation.*** Failure of finance companies in Thailand to honour their commitments led to a speculative attack on Thailand's currency baht forcing the Thai authorities to abandon their earlier exchange rate system of pegged currency and allowing the baht to float on July 2, 1997. This floating of the baht led to its immediate devaluation by nearly 20 per cent against the dollar. The contagion effect of the currency crisis in Thailand was felt in other countries of Southeast and East Asian region as well particularly Indonesia, Philippines and South Korea. There was a large-scale reversal of short-term flows from these countries. Short-term flows to Asia declined from net inflows of US $ 69 billion in 1996 to net outflow of US $ 104 billion in 1997.

As is clear from the above, if the domestic economy does not perform well for any reason whatsoever, there is a tendency for money to flow abroad. Thus, ***the benefits of outflows are negatively correlated to the health of the domestic economy***. Under full capital account convertibility, if an economy does not perform well (or if some other economies perform much better), there will be massive capital outflows from the economy. Thus, an already 'bad' situation would turn 'worse'. While a few individual investors would benefit, the country would lose. "The risk-reward relationship of liberal outflows by residents is not acceptable as it will benefit only the few, and that too when the many, if not most, are in misery."[13]

India's Approach to Capital Account Convertibility

On account of the dangers of full capital account convertibility and the unhappy experience of other countries who opted for such convertibility, the Reserve Bank of India opted for a gradualist and phased capital account liberalisation programme. ***It started off by opting first for current account liberalisation in stages.*** By August 1994, this process was completed with India accepting obligations under Article VIII of the IMF's Articles of Agreement. Subsequently, capital account transactions were gradually liberalised. Restrictions on inflows were relaxed first. While liberalising the inflows, there was an emphasis on encouraging foreign direct investment and portfolio investment which were progressively liberalised. Liberalisation of commercial borrowings was also undertaken but focus here was concentrated on liberalisation of long-term borrowings while short-term debt-creating inflows were discouraged. Recently, with consolidation in the external sector, restrictions on outflows have also been liberalised.

The framework of Reserve Bank's approach to capital account convertibility was provided by Report of the Committee on Capital Account Convertibility (Chairman: S.S. Tarapore) submitted in May 1997. For the purpose of its Report, ***the Committee defined capital account convertibility (CAC) as the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange.*** It can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature. The Committee did not recommend unlimited opening up of capital account, but preferred a phased liberalisation of controls on outflows and inflows over a three-year period (ending 1999-2000). Even at the end of the three-year period, capital account was not to be

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fully open and some flows, especially debt would continue to be managed. ***The three crucial preconditions laid down by the Committee for attaining CAC were (i) fiscal consolidation, (ii) a mandated inflation target, and (iii) strengthening of the financial sector. As a prerequisite for CAC, the Committee had laid down that the current account deficit should not exceed 1.6 per cent of GDP and the combined fiscal deficit of Centre and States should be around 3.5 per cent of GDP. In addition, the Committee stressed that important macroeconomic indicators should also be assessed on an ongoing basis.***

Important Capital Account Liberalisation Measures

The purpose and the spirit of measures undertaken in India since 1997-98 to open up the capital account have been broadly in line with the recommendations of the Report of the above-mentioned Committee, while the time-table itself has assumed lesser significance. Important capital account liberalisation measures undertaken in India during recent years are as follows:

1. All deposit schemes for NRIs have been made fully convertible.

2. NRIs will be free to repatriate in foreign currency their current earnings in India such as rent, dividend, pension, interest and the like based on appropriate certification.

3. Indian citizens have been permitted to maintain foreign currency accounts out of foreign exchange earned/ retained from travel expenses.

4. Both, listed Indian companies and resident individuals have been permitted to invest abroad in companies listed in recognised overseas stock exchanges, and having at least 10 per cent shareholding in a company listed on a recognised stock exchange in India, on January 1 of the year of investment.

5. Indian companies are allowed to access ADRs/ GDRs (American Depository Receipts/Global Depository Receipts) markets through an automatic route without approval of the Ministry of Finance subject to specified norms and post-issue reporting requirements.

6. FDI is allowed upto 100 per cent on the automatic route in most sectors subject to sectoral rules/regulations applicable.

7. Indian parties are allowed to make direct investment in a joint venture/wholly owned subsidiary outside India without prior approval of the Reserve Bank/Government subject to certain conditions.

8. Investment in overseas financial sector is also permitted subject to certain terms and conditions.

9. A person resident in India being an individual is permitted to acquire foreign securities by way of gift, inheritance or under cashless Employees Stock Option Scheme (ESOP). In addition, employees or directors of the Indian office/branch/subsidiary of a foreign company or an Indian company are permitted to acquire ESOPs against remittance without any monetary limit.

10. Indian corporates who have set up overseas offices have been allowed to acquire immovable property outside India for their business as well as staff residential purpose.

11. ADs (Authorised Dealers) in India are permitted to borrow in foreign currency subject to certain conditions.

12. Mutual Funds have been permitted on application, after obtaining necessary permission from SEBI, to invest in ADRs/GDRs of Indian companies and rated debt instrument in overseas market. Recently, they have also been permitted to invest in equity of overseas company, subject to conditions applicable to corporates/individuals.

13. General permission has been granted to registered foreign institutional investors to purchase shares/convertible debentures of an Indian company through offer/private placement subject to specified ceiling.

14. The Reserve Bank has allowed the resident Indians to remit up to $ 25,000 a calendar year for any current or capital account transaction, or a combination of both (this limit has been raised in a phased manner to $ 2,00,000). This provision enables resident Indians not only to open and operate foreign currency accounts outside India, but also to use the money remitted to those accounts to acquire financial or immovable assets without prior approval from Reserve Bank.

15. As per guidelines issued on January 12, 2005, (*i*) transfer of shares in an existing Indian company has been allowed under automatic route except in certain cases; (*ii*) conversion of ECB/loan into equity has been allowed under the automatic route provided the activity is covered under the automatic route and the foreign equity after such conversion falls within the sectoral cap; and (*iii*) conversion of preference shares into equity has been allowed under the automatic route provided the increase in foreign equity participation is within the sectoral cap in the relevant sectors and the activity is under the automatic route.

16. On June 25, 2012, RBI announced the following measures for capital account liberalisation: (*i*) Indian companies in manufacturing and infrastructure sectors and having foreign exchange earnings were allowed to avail of external commercial borrowing for repayment of outstanding Rupee loans towards capital expenditure and/or fresh Rupee capital expenditure under the approval route. The overall ceiling for such external commercial borrowings would be

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US $ 10 billion; (*ii*) The then prevailing limit for investment by SEBI registered foreign institutional investors in Government securities (G-Secs) was enhanced by a further amount of $ 5 billion (this raised the overall limit for FII investment in G-Secs from US $ 15 billion to US $ 20 billion). In order to broad-base the non-resident investor base for G-Secs, it was also decided to allow long-term investors like Sovereign Wealth Funds (SWFs), multilateral agencies, endowment funds, insurance funds, pension funds and foreign central banks registered with SEBI, to also invest in G-Secs for the entire limit of $ 20 billion; and (*iii*) Qualified Foreign Investors (QFIs) were allowed to invest in those mutual funds (MF) schemes that held at least 25 per cent of their assets in infrastructure sector under the US $ 3 billion sub-limit for investment in mutual funds related to infrastructure.

The above discussion shows that a number of steps have been announced in the post-1991 period to liberalise the capital account. However, in recent times, recessionary trends have been witnessed in many major economies of the world and protectionist measures are being increasingly pursued all over the world. In such a gloomy environment, capital controls become a necessity and no virtue is seen in opening up of capital accounts and making currencies fully convertible. Indeed, as pointed out by Rajwade, "If financial stability, which the money men keep emphasising, is the objective, it is best to forego, out of the impossible trinity, liberal capital flows but not managed exchange rates or an independent monetary policy. Indeed, volatile exchange rates are an impediment to greater globalisation of the real economy! On the subject of capital flows and exchange rates, we perhaps need to learn much more from China than from the IMF."[14]

NOTES

1. Reserve Bank of India, *Report on Currency and Finance* 2002-03 (Mumbai, 2004), p. 198.
2. A.V. Rajwade, "Risks and Rewards of Capital Account Convertibility", *Economic and Political Weekly*, January 6, 2007, pp. 33-4.
3. The meaning of 'sterilisation' is explained later in this chapter (see the sub-section, "India's Approach to Reserve Management").
4. Suresh D. Tendulkar, "India in the World Trading System: A Quantitative Assessment", in T.N. Srinivasan and Suresh D. Tendulkar, *Reintegrating India with the World Economy* (New Delhi, 2003), p. 16.
5. Reserve Bank of India, *Report on Currency and Finance* 1998-99, p. XI-7.
6. Current account convertibility is defined as the freedom to buy or sell foreign exchange for the following international transactions: (*i*) all payments due in connection with foreign trade, current business, including services, and normal short-term banking and credit facilities; (*ii*) payments due as interest on loans and as net income from other investments; (*iii*) payments of moderate amount of amortisation of loans or for depreciation of direct investments; and (*iv*) moderate remittances for family living expenses.
7. Reserve Bank of India, *Annual Report* 2016-17 (Mumbai, 2017), Appendix Table 1, p. 216.
8. Reserve Bank of India, *Report on Currency and Finance* 2002-03, *op. cit.*, p. 187.
9. C.P. Chandrasekhar, "Opening the Sluice Gates", *Frontline*, February 27, 2004, p. 117.
10. Jayati Ghosh, "Policies for the External Sector", *Social Scientist*, Vol. 3, Nos. 9-10, Sept-Oct. 2003, p. 103.
11. A.V. Rajwade, *op cit.*, p. 30.
12. 'Hot money' refers to short-term funds which move about in international capital market for maximising returns on investments.
13. A.V. Rajwade, *op. cit.*, p. 33.
14. A.V. Rajwade, "Liberal Capital Flows", *Economic and Political Weekly*, May 26, 2012, p, 20.

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41 Chapter

MULTINATIONAL CORPORATIONS, FERA AND FEMA

Multinational Corporations (MNCs) are huge industrial organisations which extend their industrial and marketing operations through a network of their branches or their Majority Owned Foreign Affiliates (MOFAs). MNCs are also known as Transnational Corporations (TNCs). Instead of aiming for maximisation of their profits from one or two products, the MNCs operate in a number of fields and from this point of view, their business strategy extends over a number of products and over a number of countries. Because of their huge capital resources, latest technology and worldwide goodwill, MNCs are in a position to sell whatever product they choose to manufacture in different countries. The fact is that people in underdeveloped countries are 'crazy' for the products of these corporations and prefer their products to the products produced indigenously.

In this chapter, we shall discuss:

- Reasons for the growth of MNCs
- Foreign collaboration and MNCs
- A critical appraisal of MNC operations on Indian economy
- Foreign Exchange Regulation Act (FERA) 1973 and Foreign Exchange Management Act (FEMA) 1999.

REASONS FOR THE GROWTH OF MNCs

Reasons for the growth of multinationals are manifold, the important ones being as follows:

1. Expansion of market territory. As the operations of a large-sized firm expand and as its international image builds up, it seeks more and more extension of its activities beyond the physical boundaries of the country in which it is incorporated.

2. Marketing superiorities. A multinational firm enjoys a number of marketing superiorities over the national firms: (*a*) It possesses a more reliable and up-to-date market information system; (*b*) It enjoys market reputation and faces less difficulty in selling its products; (*c*) It adopts more effective advertising and sales promotion techniques; and (*d*) It has efficient warehousing facilities due to lower inventory requirements.

3. Financial superiorities. A multinational firm enjoys the following financial superiorities over the national firm: (*a*) It has huge financial resources with which it can easily turn all circumstances in its favour; (*b*) It maintains a high level of funds utilisation by generating funds in one country and using them in another; (*c*) It has easier access to external capital markets; and (*d*) Because of its international reputation it is able to raise more international resources. Even investors and banks of the host country are eager to invest in it.

4. Technological superiorities. The main reason why MNCs have been encouraged by the underdeveloped countries to participate in their industrial development is on account of the technological superiorities which these firms possess as compared to national companies. The underdeveloped countries regard transfer of technology from MNCs useful on account of the following reasons: (*a*) Industrialisation represents the most important way out of underdevelopment and the resources of these countries are insufficient to sustain the industrial progress on their own; (*b*) Local manpower, materials, local capital equipment etc. have to be optimally exploited and these countries are unable to accomplish this; (*c*) Depending totally on local companies would require heavy imports of raw materials, capital equipment, machinery and technical knowledge whereas MNCs bring these on their own; and (*d*) The underdeveloped countries have to face stiff competition for selling their products in international markets. Unless their goods meet international standards and quality specifications, they cannot sell. MNCs help them in producing such goods.

5. Product innovations. MNCs have Research and Development Departments engaged in the task of developing new products and superior designs of existing products. Therefore, their production opportunities are far greater as compared to national companies.

FOREIGN COLLABORATION AND MNCs

A common form of MNC participation in Indian industry is through entering into collaboration with Indian industrialists. Foreign collaboration agreements are made between Indian companies and foreign parties, involving sale of technology, as well as use of foreign brand names

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for the final products. The enormity of foreign collaborations entered into by the Indian companies would be clear from the fact that in nearly all of the new industries in the large or medium size group, privately or publicly owned, set up after Independence, some collaboration agreement was present. Trends of liberalisation in the 1980s gave a substantial spurt to foreign collaborations. As a result of liberalised foreign investment policy announced in July-August 1991, there has been a further spurt of foreign collaborations and increased flow of foreign direct investment.

The policy of the government in the field of foreign collaboration has been criticised on the following counts:

(*i*) A large number of agreements were concluded for the manufacture of products which are non-essential or which could be produced with the help of local technology. These items included vacuum flasks, lipstick, toothpaste, cosmetics, ice-cream, biscuits, dry batteries, readymade garments etc. Clearly such collaborations were directed to serve the needs of high income groups and to take advantage of a foreign brand name;

(*ii*) The government permitted multiple collaborations, *i.e.*, repetitive import of the same or similar technology. This resulted in repetitive payments without adding to the stock of technical knowledge in the country;

(*iii*) The terms of agreements were mostly weighted in favour of the foreign collaborators and were against Indian interests. This arose on account of the lack of bargaining power in the Indian side and the government's eagerness to acquire foreign participation in the face of foreign exchange shortage;

(*iv*) Since the responsibility of specification and supply of equipment was entrusted to the foreign collaborators, there was close tie-up between the designers and suppliers resulting not only in price mark-up but also in over-import of equipment. Sometimes equipments were imported even when they were available locally, sometimes they remained idle for want of spares, and often the processes were more highly mechanised and sophisticated than was desirable or necessary. At times, obsolete technology was imported;

(*v*) The terms of payment were also drawn up so as to squeeze out the maximum payment under one head or other. Generally 5 per cent of the annual turnover for 10 years as royalty plus 5 per cent of the imported plant cost as technical fees in the case of royalty-cum-technical fees, or 10 per cent of the issued capital as lumpsum payment for technical fees alone, were the limits of official policy. However, these tended to become routine;

(*vi*) The most important part related to the presence of various restrictive clauses in the agreements. Some restrictions imposed were: (*a*) the technology cannot be passed on to any one else, in some cases even after the expiry of the agreement; (*b*) manufacturing is to be carried out according to the specifications laid down by the collaborator and no local adaptations can be made; (*c*) control over overseas purchase was exercised through the provision that it had to be made directly or indirectly through the collaborator; (*d*) production was tightly controlled at times through the posting of foreign technicians; (*e*) controls over the pricing and marketing of the products were exercised by requiring that a part of the production was to be sold to the collaborator's subsidiary in India at a fixed commission or that specified firms were to be made the sole selling agents; and (*f*) right to export was also restricted by the provision that exports could be done only to specific countries or on certain preconditions, and

(*vii*) Foreign collaborations have helped the growth of monopolies and concentration. They joined hands with the big business houses and the latter were only too eager to enter into understanding with them since the presence of foreign links often conferred certain strategic advantages (patent, resources, foreign exchange, etc.) enabling the big business houses to diversify and expand.

A CRITICAL APPRAISAL OF MNC OPERATIONS ON INDIAN ECONOMY

The operations of MNCs open up the possibilities of interference in the industrial (and other) activities of the recipient country and are thus resented by the 'nationalist' thinkers. Their arguments against the operations of MNCs can be summed up as follows:

1. Payment of dividends and royalty. A large sum of money flows out of the country in terms of payment of dividends, profits, royalties, technical fees and interest to the foreign investors. Royalty payments by the Indian arms of MNCs have spurted after 2009 when the Central government waived restrictions in this regard. In fact, the royalty payments have increased faster than the growth in revenues and profits and this is not a healthy trend. A study by proxy advisory firm Institutional Investor Advisory Services (IiAS) shows that 32 MNCs in the BSE 500 index paid royalty of ₹ 7,100 crore in 2015-16, which was 21 per cent of their pre-tax pre-royalty profits. In fact, ***for the five years ending 2015-16, MNC royalty payments grew at 13 per cent, in excess of their pre-tax profits which grew at 9.6 per cent.***[1]

Being commercial arrangements, minority shareholders do not have any say on the terms and conditions of royalty/technology fee payments. The key concerns of minority investors are: (*i*) How to quantify the technical know-how fees offered/royalty paid? (*ii*) Is the use of brand name and

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trademark actually driving up sales? (*iii*) What impact has the latest know how had on margins? and (*iv*) Has the use of latest technology materially reduced expenditure on manufacturing-related costs?[2]

2. Distortion of economic structure. MNCs can inflict heavy damage on the host country in various forms such as suppression of domestic entrepreneurship, extension of oligopolistic practices (such as unnecessary product differentiation, heavy advertising, or excessive profit taking), supplying the economy with unsuitable technology and unsuitable products, worsening of income distribution by distorting the production structure to meet the requirements of high-income elites, etc.

3. Political interference. Because of their immense financial and technical power, the MNCs have gained the necessary strength to influence the decision-making processes in underdeveloped countries. Though they do help in transferring technology to underdeveloped countries, it has been often found that models and patterns of industrial development and technologies transferred are not in harmony with the interests of the host countries. The governments of underdeveloped countries have also felt threatened by the direct and indirect interference of MNCs in their internal affairs. The autonomy and sovereignty of the host countries is in danger. Because of these reasons, the governments of various countries have sought to restrict the activities of MNCs in their economies through a battery of administrative controls and legal provisions.

4. Technology transfer not necessarily conducive to development. As far as transfer of technology to underdeveloped countries is concerned, the behaviour pattern of MNCs reveals that they do not engage in R&D activities within the underdeveloped countries. Their R&D efforts are concentrated in laboratories in the home country or in other industrialised countries. Though R&D activities continue to be centralised in the parent country, the host countries have to bear the bulk of their costs since the affiliates of the MNCs in these countries remit payments on this account generally in relation to their sales volume. Such payments by the affiliates are generally over and above those remitted in the form of royalties and technical fees to the parent firm. The satisfaction expressed on technology transfer is partly misconceived also on account of the fact that MNCs which generally command a semi-monopolistic position in their product lines do not transfer their first-line or most advanced technology until foreign firms compel them to do so. ***In many cases, the technology transferred is of a capital-intensive nature which is not useful from the point of view of a labour surplus economy.*** In fact, continued insistence on the import of such technology can have serious consequences for the economy of the host country since unemployment will increase. Also, market will fail to grow and this constraint alone would suffice to restrain the rate of growth from increasing.

CONTROL OVER MULTINATIONAL CORPORATIONS

The responsibility of controlling the activities of multinational corporations in India rests on different government agencies. These agencies are: (*i*) the Ministry of Company Affairs, (*ii*) the Reserve Bank of India, (*iii*) the Ministry of Industrial Development, and (*iv*) the Ministry of Finance. However, these agencies do not work in close cooperation with each other. As a result, there is no coordination in their functioning. Each case is discussed on its own merits by the authorities. There are no objective criteria for approving applications and the procedure resorted to by the various ministries is lengthy and cumbersome.

As a result of a study by Michael Kidron entitled *Foreign Investment in India* published in 1965 (and the follow-up discussions in which many economists participated) and the appearance of the Industrial Licensing Policy Inquiry Committee Report in 1968, the belief got strengthened that imports of foreign technology were overpriced and were designed to perpetrate dependence. As a consequence, the government policy was progressively tightened in the following directions:[3] (1) Some industries were not allowed to import technology at all, the underlying principles of the policy being that (*a*) no 'inessential' article should be produced with fresh imports of technology (this gave the existing domestic and foreign producers automatic protection against fresh imports of technology) and (*b*) where domestic capacity was 'adequate' no technology should be imported; (2) Among industries where technology imports were allowed, the maximum rate of royalty was laid down; (3) In some designated industries, foreign investment was allowed in principle, but sanction in individual cases was a matter of administrative decision; (4) The normal permissible period of agreements was reduced from ten years to five, and renewals were generally frowned upon; (5) Exports and other marketing restrictions were generally not allowed, and often an obligation to export a certain proportion of the output was insisted upon; (6) A clause was often inserted in the agreements granting permission to the importer to sub-licence the technology; (7) The CSIR was allowed to look at applications for approval of technology imports, and if it expressed willingness to supply the technology, approval was withheld or at least delayed.

The most effective curb on the activities of foreign companies, especially MNCs, was supposed to come with

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the passing of the Foreign Exchange Regulation Act (FERA) in 1973 to which we now turn.

FOREIGN EXCHANGE REGULATION ACT (FERA), 1973

Foreign Exchange Regulation Act (FERA) was promulgated in 1973 and it came into force on January 1, 1974. ***Section 29 of this Act referred directly to the operations of MNCs in India. According to the Section, all non-banking foreign branches and subsidiaries with foreign equity exceeding 40 per cent had to obtain permission to establish new undertakings, to purchase shares in existing companies, or to acquire wholly or partly any other company.*** Guidelines for administering this Section of FERA were announced in 1973 and later amended in 1976.

According to these guidelines, the principal rule was that all branches of foreign companies operating in India should convert themselves into Indian companies with at least 60 per cent local equity participation. Furthermore, all subsidiaries of foreign companies should bring down the foreign equity share to 40 per cent or less. Exempted from these rules were, however, companies exporting a substantial part of their production, and companies engaged in core sectors and priority industries. In these cases, the guidelines provided for higher levels of foreign equity. According to Martinussen, "these exceptions to the general rule reflected the government's endeavours to induce TNCs to use their superior access to global distribution and marketing system, with a further view to improving India's balance of payments position. Besides, they reflected a desire on the part of the Indian government to channel TNCs away from certain industries and into core sectors and high priority industries. The latter included primarily basic intermediates and capital goods, whereas the former group comprised mainly consumer goods. As a rule, the manufacture of priority items required sophisticated technology not available from indigenous source".[4]

Implementation of FERA. There were substantial delays in implementing FERA. According to Martinussen, by June 1979, only about half the companies directed to dilute the foreign holdings had carried out the process as stipulated. Most of the companies were in the process of diluting, but 64 companies had, at that time, yet to initiate the process. Not until 1982, *i.e.,* eight years after FERA came into force, did the last group of 28 companies receive final directions pursuant to the Act. Moreover, upto the end of 1985, a total of 252 foreign controlled companies were exempted from the general rule stipulating a maximum of 40 per cent non-resident interest.[5]

In regard to the companies that did not comply with FERA regulations, Martinussen observes a certain pattern. For instance, he found that almost all these companies belonged to only three groups. They were either engaged in tea plantation activities or in the manufacture of drugs and pharmaceuticals, or they were affiliated with particularly large TNCs. The special treatment to tea companies was due to the importance of tea in India's foreign trade. As far as the drugs and pharmaceuticals industry is concerned, India's heavy dependence on MNCs for bulk drugs came in the way of compliance of FERA regulations. As far as the third category of powerful MNCs in concerned, Martinussen gives in detail the experience with regard to Hindustan Lever Ltd.[6] This company managed to secure concessions from the government on flimsy grounds. For instance, it succeeded in getting 60 per cent of its toiletries manufacturing classified by government as high technology activity as it helped in 'import substitution'.

The general conclusion that emerges from a review of FERA is that it did not in any significant way restrict the expansion and activities of TNC affiliated companies in general. In fact, "the overwhelming majority of large, well-established and experienced TNC affiliated companies were able to extract sizeable benefits from the working of the approval system, not necessarily in keeping with government policy. In other words, the approval system proved ineffective as a regulatory framework in relation to resourceful TNCs that chose to come to terms with the system."[7]

New Concessions for FERA Companies

In line with the liberalisation measures announced in the new industrial and trade policy in 1991 and the subsequent period, the government announced major concessions to FERA companies in November 1991 and January 1992. On January 8, 1993, the government promulgated an Ordinance to amend FERA with immediate effect. The Ordinance removed a large number of restrictions on companies with more than 40 per cent non-resident equity, removed FERA controls on Indian firms setting up joint ventures abroad and allowed Indians to hold immovable property abroad, subject to certain conditions. Important concessions announced in November 1991, January 1992 and January 1993 were as follows:

(1) Companies with foreign shareholding were allowed to increase foreign equity to 51 per cent by remittances in foreign exchange in specified high priority industries; (2) Section 26, sub-section 7, which required the FERA companies to get Reserve Bank's permission before raising working capital or accepting deposits was revoked; (3) Sections 28 and 29 were revoked. This meant that FERA

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companies could now use their trade marks in India and could carry on in India any activity of a trading, commercial or industrial nature; (4) Section 31 was revoked. This allowed FERA companies to deal in immovable property in India; (5) Section 27 which restricted Indian companies setting up joint ventures abroad and resident Indians associating themselves with or taking part in overseas concerns was scrapped; (6) Restrictions regarding assets held in India by non-residents were removed; (7) Indians were allowed to keep foreign currency upto $ 500 or ₹ 15,000; (8) Import and export in gold and silver was exempted from FERA implying that these commodities were now to be governed by Exim policy; (9) Section 17 which conferred powers on the government to regulate uses of imported gold and silver was deleted; (10) Restrictions on transfers of any security from a register in India to a register outside India were removed; (11) Restrictions on transfers of shares by a non-resident to another non-resident were removed; (12) The provision allowing the government to acquire foreign securities for purposes of strengthening foreign exchange position had never been invoked and was unlikely to be invoked. Since this provision could cause avoidable apprehensions and fears in foreign investors, it was deleted; (13) Foreign nationals were exempted from obtaining prior permission under FERA before taking up employment in India; (14) A FERA provision which provided that the Government could direct certain payments to be made by FERA companies in a special account, was deleted.

The above list of concessions shows that FERA was made redundant and efforts were made to place FERA companies at par with Indian companies. In fact, the Union Budget, 1998-99, advocated repealing FERA and replacing it with FEMA (Foreign Exchange Management Act) as, according to the government, FERA was out of tune with the changing times. According to the Finance Minister, since the country has moved to full current account convertibility and there is opening up of foreign exchange markets and transactions, "it is no longer appropriate to deify foreign exchange as something special and maintain a burdensome and highly regulatory structure around this deity."[8] Consequently, the government adopted FEMA in 1999. Under FEMA, the emphasis is on 'management' rather than 'regulation.'

FOREIGN EXCHANGE MANAGEMENT ACT (FEMA), 1999

The Foreign Exchange Management Bill (FEMA) was introduced by the Government of India in Parliament on August 4, 1998. The Bill aims ***"to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India."*** It was adopted by the Parliament in 1999 and is known as the Foreign Exchange Management Act, 1999. Chapter II of FEMA deals with the regulation and management of foreign exchange. Section 3 states that except as otherwise provided in this Act, no person shall in any manner deal in or transfer any foreign exchange or foreign security to any person not being an authorised person. Section 4 states that except as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Current Account and Capital Account Transactions. Sections 5 and 6 deal with current account and capital account transactions. According to Section 5, any person may sell or draw foreign exchange to or from an authorised person if such sale or drawal is a current account transaction. However, the Central government may, in public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed. According to Sub-section 1 of Section 6, any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction subject to provisions of Sub-section 2. Sub-section 2 states that Reserve Bank may, in consultation with the Central government, specify — (*a*) any class or classes of capital account transactions which are permissible; (*b*) the limit upto which foreign exchange shall be admissible for such transactions.

Sub-section 4 of Section 6 states that a person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. Sub-section 5 states that a person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

Realisation and Repatriation of Foreign Exchange. Section 8 lays down that save as otherwise provided in the Act, where any amount of foreign exchange is due or has accrued to any person resident in India such person shall take all reasonable steps to realise and repatriate to India such foreign exchange within such period and in such manner as may be specified by the Reserve Bank.

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Section 9 provides the following exemptions from realisation and repatriation of foreign exchange: (*a*) possession of foreign currency or foreign coins by any person up to such limit as the Reserve Bank may specify; (*b*) foreign currency account held or operated by such person or class of persons and the limit up to which the Reserve Bank may specify; (*c*) foreign exchange acquired or received before the 8th day of July, 1947 or any income arising or accruing thereon which is held outside India by any person in pursuance of permission granted by the Reserve Bank; (*d*) foreign exchange held by a person resident in India upto such limit as the Reserve Bank may specify, if such foreign exchange was acquired by way of gift or inheritance from a person referred to in clause (*c*), including any income arising therefrom; (*e*) foreign exchange acquired from employment, business, trade, vocation, services, honorarium, gifts, inheritance or any other legitimate means upto such limit as the Reserve Bank may specify; and (*f*) such other receipts in foreign exchange as the Reserve Bank may specify.

Contravention and Penalties. Chapter IV deals with the issue of contravention and penalties. Section 13 says that if any person contravenes any provisions of this Act he shall, upon adjudication, be liable to a penalty upto thrice the sum involved in such contravention where such amount is quantifiable, or upto two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. Section 14 says that if the person concerned fails to make full payment of the penalty imposed on him within a period of ninety days, he shall be liable to civil imprisonment.

Adjudication and Appeal. Chapter V deals with the issue of adjudication and appeal. Section 16 states that the Central government may appoint Adjudicating Authorities for holding an inquiry in the manner prescribed after giving the accused person a reasonable opportunity of being heard for the purpose of imposing any penalty. Section 17 provides for the appointment of one or more Special Directors (Appeals) to hear appeals against the orders of the Adjudicating Authorities. Section 18 says that the Central government shall, by notification, establish an Appellate Tribunal to be known as the Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the Adjudicating Authorities and the Special Director (Appeals) under this Act.

Directorate of Enforcement. Chapter VI deals with the establishment of the Directorate of Enforcement and its powers, etc. Sub-section 1 of Section 36 states that the Central government shall establish a Directorate of Enforcement with a Director and such other officers or class of officers as it thinks fit, who shall be called Officers of Enforcement, for the purpose of this Act. Sub-section 3 of Section 37 states that the Director of Enforcement and other officers of Enforcement shall exercise the like powers which are conferred on Income-tax authorities under the Income-tax Act, 1961 and shall exercise such powers, subject to such limitations laid down under the Act.

Miscellaneous. The last chapter, Chapter VII consisting of Sections 39 to 49 deals with miscellaneous issues. Sub-section 1 of section 40 empowers the Central government in the public interest and by notification to suspend or relax the provisions of the Act in certain circumstances. Section 41 empowers the Central government to give general or special directions to the Reserve Bank. Section 42 provides that where contravention of any of the provisions of this Act is committed by a company, the person responsible for the conduct of its business shall be deemed to be guilty of the contravention. Section 44 bars the prosecution of legal proceedings against the officers of the Central government or the Reserve Bank or any other person exercising any powers or discharging any functions or performing any duties under the provisions of this Act for anything done in good faith. Section 45 empowers the Central government to remove the difficulties in giving effect to the provisions of the Act. Section 46 empowers the Central government to frame the rules and Section 47 empowers the Reserve Bank to make regulations to carry out the provisions of this Act and the rules made thereunder. Section 48 provides for laying before Parliament the rules and regulations made under this Act. Section 49 provides for repeal of the Foreign Exchange Regulation Act, 1973 and for dissolution of the Appellate Board constituted under Section 52 of the said Act.

FEMA: A MAJOR DEPARTURE FROM FERA

As is clear from the name of the Act itself, ***the emphasis under FEMA is on 'exchange management' whereas under FERA the emphasis was on 'exchange regulation' or exchange control.*** Under FERA it was necessary to obtain Reserve Bank's permission, either special or general, in respect of most of the regulations thereunder. FEMA has brought about a sea change in this regard and ***except for Section 3 which relates to dealing in foreign exchange, etc., no other provisions of FEMA stipulate obtaining Reserve Bank's permission.***[9] The demand for new legislation was basically on the following counts: (*i*) FERA was introduced in 1974 when India's foreign exchange reserve position was not satisfactory. Accordingly, stringent controls were required on the use of foreign exchange. With improvement in foreign exchange position,

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it is argued that such stringent controls are not now required; (*ii*) India had given notice to the IMF in August 1994 that it had attained Article VIII status. This notice meant that no restrictions will be imposed on remittances of foreign exchange on account of current account transactions; and (*iii*) the private corporate sector had been complaining for long against, what it termed, the 'draconian provisions' of FERA which gave unbridled powers to the Enforcement Directorate to arrest any person, search any premises, seize documents and start proceedings against any person for contravention of FERA or for preparations of contravention of FERA. The contravention under FERA was treated as a criminal offence and the burden of proof was on the guilty.[10]

FEMA has changed all this. As stated earlier, the purpose of FEMA is to 'facilitate external trade and payments' and 'promote the orderly development and maintenance of foreign exchange market in India.' As far as the promotion of orderly development and maintenance of foreign exchange market is concerned, FEMA is silent. However, as far as facilitating external trade is concerned, Section 5 removes restrictions on drawals of foreign exchange for the purpose of current account transactions. As external trade, *i.e.*, import and export of goods and services, involves transactions on current account, there will be no need for seeking the permission of Reserve Bank of India in connection with remittances involving external trade. However, Section 5 confers powers on the Central Government to impose reasonable restrictions on current account transactions, in consultation with the Reserve Bank. But this seems to be just an 'enabling provision' added keeping in view the experiences of some East Asian countries during the 1997-98 crises which required stricter exchange controls.[11] As far as the 'draconian provisions' are concerned, FEMA has reduced their rigour significantly. For instance, unlike in the case of FERA, violations of FEMA will not attract criminal proceedings. The contravention will now be treated as a civil offence. Thus FEMA removes the "threat of imprisonment" which businessmen abhor. Now they will either compound their illegal acts by paying a fine if it is not too high, otherwise they will pay lawyers to engage in lengthy (and mostly inconclusive) litigation with the government.

According to Biswajit Dhar and Mritunjay Mohanty, FEMA represents major departures from the past policies in two other important respects: "First, it can be seen as an initial step towards capital account convertibility. Secondly, by removing the FERA from the statute book and replacing it with the FEMA, the government seems to have finally decided to give up even the bare intention of regulating foreign capital in the country."[12] The latter is an important message coming at a time when the international institutions, under the leadership of developed countries, are putting a multilateral investment regime in place that would free foreign investors from any controls which host countries might feel the need to impose. Although India has maintained that it would preserve its sovereign rights to regulate foreign investment, the absence of FERA is likely to pose serious difficulties in this effort.

NOTES

1. Editorial, *Business Standard*, September 15, 2017, p. 11.
2. Sudipto Dey and N. Sundaresha Subramanian, "Showing Loyalty with Royalty", *Business Standard*, December 21, 2012, p. 3; and Krishna Kant, "Royalty Bigger than Dividends for MNCs", *Business Standard*, January 18, 2014, p. 1.
3. Ashok V. Desai, "US Corporations as Investors in India", *Economic and Political Weekly*, 8 December, 1979, p. 2020.
4. John Degnbol-Martinussen, *Policies, Institutions, and Industrial Development — Coping with Liberalisation and International Competition in India* (New Delhi, 2001), p. 102.
5. *Ibid.*, pp. 104-5.
6. In this context, see Martinussen's earlier book *Transnational Corporations in a Developing Economy — The Indian Experience* (New Delhi, 1988).
7. Martinussen (2001), *op. cit.*, pp. 106-7.
8. "Union Budget 1998-99: Speech of the Finance Minister", *The Economic Times*, June 2, 1998, p. 1.
9. Rashmin Sanghvi, Naresh Ajwani and K.G. Chaudhury, *Guide to Foreign Exchange Management Act*, 1999 (New Delhi, 1999), p. 12.
10. *Ibid.*, p. 14.
11. *Ibid.*, p. 13.
12. Biswajit Dhar and Mritunjay Mohanty, "FEMA: A Closer Look", *Economic and Political Weekly*, October 3, 1998, p. 2569.

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42 Chapter

GLOBALISATION AND ITS IMPACT ON THE INDIAN ECONOMY

In this chapter, we shall discuss:

- Meaning of globalisation
- Steps taken to globalise the Indian economy
- Effects of globalisation on the external sector and the domestic sector of the Indian economy.

MEANING OF GLOBALISATION

Globalisation means different things to different people. According to Deepak Nayyar, "It (globalisation) can be defined, simply, as an expansion of economic activities across political boundaries of nation states. More importantly, perhaps, it refers to ***a process of deepening economic integration, increasing economic openness and growing economic interdependence between countries in the world economy.*** It is associated not only with a phenomenal spread and volume of cross-border economic transactions, but also with an organisation of economic activities which straddles national boundaries."[1] ***From an economic point of view, globalisation happens through three channels: (i) trade in goods and services, (ii) movement of capital, and (iii) flow of finance.***

The first step in the direction of globalisation was liberalisation in trade of goods and services which led to an unprecedented expansion of international trade between 1950 to 1970. This was followed by the liberalisation of regimes for foreign investment leading to a surge in international investment which began in the late 1960s. This had two dimensions: (*i*) the deregulation of the domestic financial sector in the industrialised countries, and (*ii*) the introduction of convertibility on capital account in the balance of payments.[2] Domestic financial liberalisation has encouraged market forces by reducing the role of the State in the financial sector. The demarcation lines between banks, insurance companies and finance companies have been considerably diluted, bond markets and equity markets have been liberalised, controls and regulations on both the inflows and outflows of capital have been removed, and institutional investors have emerged in the developed countries who are both willing and able to invest in global markets. Multinational corporations (MNCs), which have their operations spread over a number of countries, have served as important 'vehicles' of globalisation as they account for a large part of foreign direct investment and of trade in goods and services.

GLOBALISATION IN INDIA

Globalisation in India is generally taken to mean 'integrating' the economy of the country with the world economy. This, in turn, implies opening up the economy to foreign direct investment by providing facilities to foreign companies to invest in different fields of economic activity in India; removing constraints and obstacles to the entry of MNCs in India (through dilutions and ultimate scrapping of restrictive laws like FERA); allowing Indian companies to enter into foreign collaborations in India and also encouraging them to set up joint ventures abroad; carrying out massive import liberalisation programmes by switching over from quantitative restrictions to tariffs in the first place (so that there is more 'transparency' in import policy), and then bringing down the level of import duties considerably; and instead of a plethora of export incentives (like duty drawbacks, cash compensatory support, replenishment licences and other fiscal incentives etc.) opting for exchange rate adjustments for promoting exports. As our discussion in the chapters on 'Industrial Policy', 'Trade Policy of the Government of India', 'Foreign Capital and Aid' and 'Multinational Corporations, FERA and FEMA' clearly shows, seeds of this globalisation process were sown in the early 1980s itself as many concessions were granted to foreign capital, MNCs were allowed to enter a number of crucial sectors to which their entry was previously restricted or banned, provisions of FERA were not strictly enforced, import liberalisation process was accelerated considerably, and downward adjustment in the exchange rate of the rupee was resorted to. However, ***the real thrust to the globalisation process was provided by the new economic policy introduced by the Government of India in July 1991 at the behest of the IMF and the World Bank.*** In all recent discussion therefore globalisation has been identified with the policy reforms of 1991 and the subsequent extension of these reforms carried out in later years.

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The 'Push' Towards Globalisation

As stated in the chapter on 'India's Balance of Payments Problem', the period after 1980-81 was marked by severe balance of payments difficulties. The second oil shock pushed up the import bill substantially while exports lagged considerably behind. Thus, trade deficit rose to astronomical heights. During Seventh Plan, private remittances also showed a tendency of flattening out. As a result, net invisibles could finance only 24 per cent of trade deficit in the Seventh Plan. The problems were compounded by the Gulf War in 1990-91. Trade deficit in this year soared to ₹ 16,934 crore and invisibles also recorded negative earnings. As a result, current account deficit was as large as ₹ 17,369 crore in 1990-91. The problem got further accentuated by India's increased reliance on high cost external commercial borrowings and non-resident deposits all through the 1980s as the flow of concessional assistance was considerably less than the requirements. Much of this borrowing on commercial terms was in the form of relatively short-term and potentially volatile instruments increasing the vulnerability of Indian economy to changes in investors' confidence and expectations. With the downgrading of India's credit rating by some international agencies consequent upon the large deficit in India's balance of payments in 1990-91 and the political uncertainties at home, the investors' confidence in the Indian economy was shaken suddenly and there was a substantial capital outflight. As stated in the section on 'Non-Resident Deposits' in the chapter 'Foreign Capital and Aid', there was a substantial withdrawal from these deposits (over $ 300 million per month over the period October 1990 to the second quarter of 1991). Despite drawing $ 1.8 billion from the Contingency Compensatory Financing Facility (CCFF) in January 1991, adopting import compression measures, and pledging gold abroad, the crisis could not be stemmed. Foreign exchange reserves dwindled to $1.1 billion in June 1991 — less than sufficient for two weeks of import requirements. Default on debt servicing appeared imminent and the Government of India was pushed to the wall. Default could be avoided only if credit was made available from the IMF or the World Bank. Assistance was indeed made available by these institutions but on their own terms and conditions. These terms and conditions entailed the adoption of a 'stabilisation and structural adjustment programme' by India.

The stabilisation and structural adjustment programme of the IMF-World Bank had the following three components, "(a) stabilisation which basically implies cutting down fiscal deficit and the rate of growth of money supply, (b) domestic liberalisation which consists of relaxing restrictions on production, investment, prices and increasing the role of market signals in guiding resource allocation, and (c) external sector liberalisation or relaxing restrictions on international flows of goods, services, technology and capital."[2] Globalisation is identified with (*c*), *i.e.*, external sector liberalisation. However, it needs to be emphasised that success on (*a*) and (*b*) fronts is crucial for the success of (*c*). For instance, stabilisation in the sense of cutting down fiscal deficit and the rate of growth of money supply are essential for keeping inflation and balance of payments under control as both these problems arise from a mismatch between aggregate demand and aggregate supply. (Foreign investment is attracted only when inflation and balance of payments are under control). Domestic liberalisation involving relaxation of restrictions on production and investment leads not only to a reduction in bureaucratic interference and controls which have since long outlived their utility but also sends 'definite positive signals' to the foreign investors about the 'genuineness' of the reform process.

The above discussion shows that the conditions that prevailed in 1990 and 1991 'pushed' India into adopting the structural adjustment programme of the IMF and World Bank. Since globalisation is a part of the structural adjustment programme, Dalip Swamy is right in stating that it were the desperate conditions of 1990 and 1991 that 'pushed' India towards globalisation.[3]

STEPS TOWARDS GLOBALISATION

We have discussed the steps towards globalisation initiated by the Government of India in 1991 and subsequent years at various places in different chapters. Here we sum up the main policy measures initiated so far under the following headings.

Exchange Rate Adjustment and Rupee Convertibility

The most important measure for integrating the economy of a country with the global economy is to make its currency fully convertible, *i.e.*, allow it to determine its own exchange rate in the international market without official intervention. This measure has to be accompanied by the lifting of exchange control measures in a phased manner. As a first step towards this measure, the IMF insisted on devaluation of the India rupee. Accordingly, ***the Government of India made a two-step downward adjustment of 18-19 per cent in the exchange rate of the rupee on July 1 and 3, 1991.*** Therefore, the first important condition laid down by the IMF for the grant of assistance was met.

In the subsequent years, the Government of India has progressively moved forward towards full convertibility. As discussed in the chapter on 'India's Exchange Rate Policy, Foreign Exchange Reserves and Capital Account

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Convertibility,' the 1992-93 Budget introduced a dual exchange rate system implying partial convertibility of rupee. The 1993-94 Budget introduced full convertibility of the rupee on trade account and switched over to a unified exchange rate system. India achieved full convertibility on current account on August 19, 1994 when the Reserve Bank accepted obligations under Article VIII of the IMF, under which India is committed to forsake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments. Many other relaxations of restrictions were announced in subsequent years.

Import Liberalisation

In its Report 'India: Strategy for Trade Reform' released in 1990, the World Bank had advocated redesigning of the import policy so that there is only one negative (restricted) list and imports of all items not explicitly on the restricted list are allowed, lowering of import tariffs on all goods, and freer entry to capital goods, intermediate goods, raw materials and consumer goods into the Indian economy. In line with these proposals, the 1992-97 export-import policy allowed the free import of all items including capital goods, except a negative list. The supplementary trade policy announced on August 13, 1991 decanalised the import of 20 items. In addition, the government has, over the years, reduced the maximum rate of import duty. The 1993-94 Budget had reduced the maximum rate of import duty from 110 per cent to 85 per cent. The successive Budgets have reduced it further in stages. ***The peak import duty on non-agricultural goods is now only 10 per cent.***

In addition to the phased reduction of import duties, India, as a member of World Trade Organisation (WTO), had also committed itself to the phasing out of quantitative restrictions over a six-year period beginning 1997. This period was further reduced following the ruling of the Disputes Settlement Body of the WTO against India on an appeal made by the USA. In terms of the agreement arrived at with USA, the quantitative restrictions have now been totally removed. Moreover, as a part of the Agreement on Trade Related Intellectual Property Rights (TRIPs), the Patents (Amendment) Act, 1999 was passed in March 1999 to provide for Exclusive Marketing Rights (EMRs). This was followed by the adoption of Patents (Amendment) Act, 2002, in May 2002 and by Patents (Amendment) Act, 2005 in March 2005.

The stock argument in favour of import liberalisation is that competition from imports would improve efficiency, quality and technology besides making international quality capital goods and inputs available to our export industries (hence increasing their competitive strength in the international markets).

Opening up to Foreign Capital

In a bid to attract foreign capital and integrate the Indian economy with the global economy, the Government of India has thrown open the doors to foreign investors. As discussed in detail in the chapters on 'Foreign Capital and Aid', 'Multinational Corporations, FERA and FEMA', and 'India's Exchange Rate Policy, Foreign Exchange Reserves and Capital Account Convertibility' various incentives and facilities have been offered to the foreign investors and non-resident Indians in the new economic policy. In 1991, the government announced a specified list of high technology and high-investment priority industries (listed in Annexure III) wherein automatic permission was granted for direct foreign investment upto 51 per cent foreign equity. The limit was raised from 51 per cent to 74 per cent and subsequently to 100 per cent for many of these industries. Presently FDI is permitted upto 100 per cent on the automatic route in most sectors subject to sectoral rules/regulations, applicable.

Many other measures have also been announced from time to time. For instance, foreign companies have been allowed to use their trade marks in India and carry on any activity of a trading, commercial or industrial nature; repatriation of profits by foreign companies has been allowed; foreign companies (other than banking companies) wanting to borrow money or accept deposits are not now required to obtain permission from the Reserve Bank; foreign companies can now deal in immovable property in India; restrictions on transfers of shares by a non-resident to another non-resident have been removed; disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank (disinvestment has now been allowed at market rates on stock exchanges with permission to repatriate the proceeds of such disinvestment); 100 per cent foreign equity participation has been allowed for setting up power plants in the country (this allows free repatriation of profits and other incentives); NRIs and overseas corporate bodies (OCBs) predominantly owned by them have been allowed to invest upto 100 per cent equity in high priority industries with repatriability of capital and income; NRI investment upto 100 per cent of equity has been allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels etc.; reputed Foreign Institutional Investors (FIIs) have been allowed to invest in Indian capital market subject to registration with the Securities and Exchange Board of India and approval of RBI; foreign direct investment under the automatic route has been permitted

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up to 100 per cent for all manufacturing activities (with certain exceptions) in Special Economic Zones (SEZs); 100 per cent foreign direct investment has been allowed in telecom sector for certain activities; 100 per cent foreign direct investment has been allowed in pharma sector, airports, hotel and tourism industry, township development, courier services and Mass Rapid Transport System (MRTS), FDI (foreign direct investment) limit in private airlines has been hiked to 49 per cent; FDI limit in private sector banks has been raised to 74 per cent, etc.

EFFECTS OF GLOBALISATION

Effects on the External Sector

The process of globalisation initiated in 1991 and the far-reaching changes in industrial and other policies have led to considerable changes on the external sector front. The Finance Minister in his Budget Speeches in 1994 and 1995 claimed the following achievements on the external front: (1) Our foreign currency reserves which had fallen to barely one billion dollars in June 1991 rose substantially to over 20 billion dollars on March 10, 1995; (2) Exporters are responding well to sweeping reforms of exchange rate and trade policies. This would be clear from the fact that as against a fall in the dollar value of exports by 1.5 per cent in 1991-92, the exports grew by over 17 per cent in the first 10 months of 1994-95. This follows a 20 per cent increase in 1993-94. Though imports also grew in line with the revival of the economy yet the balance of payments situation is comfortable; (3) The fears expressed in some quarters that our trade policy would generate a disruptive flood of imports and weaken our economy have been shown to be completely unfounded. Liberalisation and openness have actually increased our self-reliance. Exports now finance over 90 per cent of imports, compared to only 60 per cent in the latter half of the 1980s; (4) The current account deficit was over 3 per cent of GDP in 1990-91. It is expected to be less than 0.5 per cent in 1994-95;[4] (5) At the time of crisis, our external debt was rising at the rate of $ 8 billion a year. In 1993-94, the increase in external debt was reduced to less than $ 1 billion. In the first half of 1994-95, our external debt stock actually declined by almost $ 300 million; (6) Contrary to what many feared, the exchange rate for the rupee has remained remarkably steady despite the introduction of full convertibility first on trade account and then on current account. Foreign exchange is flowing through legal channels in ample quantities instead of through illegal (*hawala*) channels earlier; and (7) International confidence in India has been restored. As a result, foreign direct and portfolio investment has increased rapidly in the last 3-4 years.[5]

However, in 1995-96, the current account deficit, as a proportion of GDP, rose to 1.7 per cent from the level of 1.0 per cent in 1994-95. Yet, as noted by the *Economic Survey* 1996-97, there was no cause of alarm as the increased deficit was easily financed by a higher level of capital inflows and a reduction in foreign exchange reserves of US $ 2.9 billion. Despite the reserve drawdown, the level of foreign currency assets at the end of 1995-96 was $ 17.0 billion, which was quite comfortable. During 1996-97, the current account deficit was 1.2 per cent of GDP. The balance of payments situation improved considerably and there was a reserve build-up of $ 5.8 billion. This was significantly higher than the average accumulation of $ 3.4 billion during 1991-92 to 1996-97. The balance of payments position in 1997-98 and 1998-99 also remained comfortable as the surplus in the capital account exceeded the deficit in the current account by a substantial margin, resulting in large accretion to foreign exchange reserves amounting to $ 3.9 billion in 1997-98 and $ 3.8 billion in 1998-99. Reserve accumulation rose to $ 6.1 billion in 1999-2000 and stood at $ 5.8 billion in 2000-01. Things were still better in 2001-02, 2002-03 and 2003-04 as there was a current account surplus in all these years because of strong positive earnings from invisibles (it was after a long gap of 24 years that a current account surplus was recorded, the last current account surplus having been registered in 1977-78). There was a substantial surplus on capital account also in these years. As a result of these two tendencies — surplus on current account and substantial inflows of capital — there was a large accretion to foreign exchange reserves of $ 11.76 billion in 2001-02, $ 16.99 billion in 2002-03 and $ 31.42 billion in 2003-04. After registering surplus for three consecutive years, the current account again saw a deficit in 2004-05. This deficit was of $ 2.5 billion. However, there was a substantial surplus of $ 28.6 billion in the capital account with the result that there was an accretion of as much as $ 26.1 billion to foreign exchange reserves in 2004-05. The current account deficit rose to $ 9.9 billion in 2005-06 while surplus on capital account was $ 24.9 billion. As a result, accretion to foreign exchange reserves in this year stood at $ 15 billion. During 2006-07, the current account deficit stood at $ 9.6 billion while surplus on capital account was as high as $ 46.2 billion with the result that accretion to foreign exchange reserves was as high as $ 36.6 billion. During 2007-08, current account deficit rose to $ 15.7 billion because of a massive trade deficit of $ 91.5 billion. However, there was a surplus of much as $ 107.9 billion in the capital account with the result that accretion to foreign exchange reserves was as high as $ 92.2 billion ***(highest in any year during the entire period of planning)***. However, things turned adverse in 2008-09

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because of global recession. As a result of this recession, capital inflows declined steeply from the level of $ 107.9 billion in 2007-08 to only $ 7.8 billion in 2008-09. With a current account deficit of $ 27.9 billion in 2008-09, ***there was a reserve drawdown of $ 20.1 billion in this year.*** Stronger recovery in India, ahead of the global recovery along with positive sentiments of global investors about India's growth prospects, encouraged a revival in capital flows during 2009-10. Net capital inflows during this year amounted to $ 51.6 billion. Since current account deficit was $ 38.2 billion, there was an accretion of $ 13.4 billion to foreign exchange reserves. The current account deficit increased to $ 48.1 billion in 2010-11 from $ 38.2 billion in 2009-10, despite improvement in net invisibles, mainly on account of higher trade deficit. However, capital account surplus rose from $ 51.6 billion in 2009-10 to $ 61.1 billion in 2010-11. As a result, there was a net accretion of $ 13.1 billion to foreign exchange reserves. Things deteriorated considerably in 2011-12 as trade deficit rose to as high as $ 189.8 billion (which was 10.2 per cent of GDP). Current account deficit in this year was $ 78.2 billion (4.2 per cent of GDP). Since surplus on capital account was $ 65.3 billion, ***there was a reserve drawdown of $ 12.8 billion in 2011-12***. The year 2012-13 saw a further rise in trade deficit to $ 195.7 billion (which was 10.6 per cent of GDP). Current account deficit in this year was $ 88.2 billion. Since surplus on capital account was $ 92.0 billion, there was a reserve accumulation of $ 3.8 billion in 2012-13. Things improved considerably in 2013-14 with current account deficit at only $ 32.3 billion. Since net capital inflows in this year were $ 47.8 billion, reserve accumulation in 2013-14 rose to $ 15.5 billion. The current account deficit in 2014-15 was $ 26.9 billion. However, there were massive capital inflows of as much as $ 88.3 billion with the result that reserve accumulation in this year was as high as $ 61.4 billion. Current account deficit in 2015-16 fell to $ 22.1 billion while surplus on capital account was $ 40.0 billion. As a result, there was a reserve accumulation of $ 17.9 billion. Because of a substantial decline in trade deficit in 2016-17 (from $130.0 billion in 2015-16 to $ 112.4 billion), current account deficit fell to $ 15.3 billion in this year (from $ 22.1 billion in 2015-16). With surplus on capital account at $ 36.8 billion, there was a reserve accumulation of $ 21.5 billion in 2016-17. Reserve accumulation in 2017-18 was as high as $42.5 billion.

In the entire post-reform period, excepting three years 1995-96, 2008-09 and 2011-12 when there was a reserve drawdown, there was substantial accretion to foreign exchange reserves in all other years. As a result, the stock of foreign exchange reserves rose from only $ 1.1 billion in June 1991 to as high as $ 4024.5 billion at end-March 2018.

Effects on the Indian Enterprises

The process of globalisation in India has led to an 'unequal competition' — a competition between 'giant MNCs' and 'dwarf Indian enterprises.' Even the large Indian enterprises are just pygmies compared to the multinational corporations and while some of them have already been gobbled up by the latter, some others are awaiting their turn with bated breath. As once noted by an MP from West Bengal, the globalisation of the Indian economy is like integrating a mouse into a herd of elephants.[6] According to Baldev Raj Nayar, the unequal competition stems from the following reasons:

1. The Indian enterprises suffer from 'size disadvantages' as they are just minuscules as compared to the MNCs.

2. The Indian corporate sector for four decades prior to 1991 operated in a protectionist environment. The quantitative restrictions and steep customs duties ensured a captive market. The industrial licensing policy of the government, in a bid to prevent the growth of monopolies, resorted to fragmentation of capacity among many producers. Thus the resources of the business houses were spread over a number of products and markets instead of intensive development of select industries. "The result was an inefficient and flabby industrial structure of agglomerative firms under family control, with fragmented capacities and without economies of scale, largely stagnant technology, dependent on the State for finance and protected market, hemmed in by the strait-jacket of controls in literally every aspect of the economy, with little experience of real competition, and with a vested interest in an economy of scarcity and shortages which the system of controls had provided."[7] How could such a sector be expected to compete with MNCs?

3. The cost of capital for Indian business is much higher than MNCs. This is due to the reason that real interest rates within the country have been much higher than those prevailing outside India.

4. Because of the immense financial strength of MNCs, they are not only in a position to bear losses in any line of business for a considerably more time than the Indian capitalists, they have enough 'muscle power' to force out the Indian partners from joint ventures and grab control of their companies. In fact, they can just buy out any Indian firm they like.

5. Indian firms continue to suffer from handicaps developed under the earlier regime of controls. For example, restructuring and downsizing of Indian companies is not easy as labour laws do not allow easy retrenchment of

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labour. As against this, MNCs start their new enterprises with modern technology and reduced requirement of labour.

6. High, multiple and cascading indirect taxes — especially at the local level, where they are not applicable to foreign imports — result in making Indian goods uncompetitive. Then, again, State has allowed imports from MNCs in areas that are reserved for the small-scale sector whereas Indian business is not allowed to produce in those areas. "From the perspective of domestic manufacturers," says Nayar, "the State has thus not been sufficiently vigilant about their interests, for it has allowed profit margins of domestic firms to be squeezed by cheaper imports."

7. In some areas, the State has pursued policies that have clearly discriminated in favour of MNCs. For example, in the power sector the State has offered counter-guarantees only to MNCs for fast-track projects without providing similar concessions to Indian firms. Then, the taxation of capital gains has favoured foreign firms with far lower rates, which could further be avoided totally if foreign firms come through Mauritius. Not only this, MNCs are allowed 100 per cent subsidiaries whereas the takeover code allows only restricted share buyback options to the Indian promoters.

On account of all these reasons, ***the process of globalisation unleashed in 1991 has 'created' a new world — a world in which not only there has been an inflow of substantial foreign capital, but the domestic corporate sector for the first time saw itself as the 'target' rather than the 'beneficiary' of the heightened activities of the foreign investors***. The swiftness, vigour and aggressiveness with which the foreign investors sought to penetrate and capture the domestic market has caused serious worry to the Indian corporate sector. Particularly, in the case of joint ventures, the MNCs have shown alarming speed in pushing over their Indian partners and gaining full control on the enterprise.

Nayar points out three strategies adopted by the MNCs to penetrate the Indian economy through FDI (foreign direct investment):[8]

1. Some foreign investors have bought off existing local brands alongwith their branded products with the aim of replacing such products with their own internationally known products, eliminating in the process the possibility of competition from the local products.
2. Some foreign investors initially opted for joint ventures with Indian partners to gain easy foothold in the domestic industry, but, once having consolidated their position, reduced the Indian partner to a subordinate position or simply ousted him. Thus, many Indian businessmen felt that MNCs simply use them as a 'doormat' for entry and spread risk at the beginning only to be dumped later.
3. Some foreign investors, even as they started out with local partners in a joint venture, then went on to set up parallel 100 per cent subsidiaries of their own in the same field, which were then favoured with greater resources and more modern technology, rendering the joint venture uncompetitive and useless.

NOTES

1. Deepak Nayyar, "Globalisation: What Does it Mean for Development?" in Bibek Debroy (ed.), *Challenges of Globalisation* (New Delhi, 1988), p. 15.
2. Alok Ray, "External Sector Liberalisation in India", *Economic and Political Weekly*, October 2, 1993, p. 2161.
3. Dalip S. Swamy, *The Political Economy of Industrialisation* (New Delhi, 1994), pp. 239-249. Indeed, as noted by Swamy (pp. 185-6) a number of Committees in the 1980s had advocated substantial liberalisation of the industrial, trade and other sectors of the economy. A powerful public opinion in favour of liberalisation had also emerged within the economy. As a result, wide-ranging changes in industrial and trade policies were introduced in 1980s as documented by us at various places in different chapters. However, the real opening up of the economy and attempts at integrating it with the world economy came up only in 1991 consequent upon the adoption of the structural adjustment programme. In all subsequent years, the process was carried still further by the Government.
4. The actual current account deficit in 1994-95, however, turned out to be 1.0 per cent of GDP.
5. "Union Budget 1995-96" — Speech of the Finance Minister, *The Economic Times*, March 16, 1995. Also see the Budget Speech, 1994-95, *The Economic Times*, March 1, 1994. Data on foreign investment are from *Economic Survey* 1995-96, Table 6.4, p. 97.
6. Baldev Raj Nayar, *Globalisation and Nationalism*, (New Delhi, 2001), p. 164.
7. *Ibid.*, p. 164.
8. *Ibid.*, p. 173.

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43 Chapter

WTO AND INDIA

In international economic relations (particularly in international trade relations), the greatest event to occur in recent times has been the setting up of WTO (World Trade Organisation) in 1995. WTO replaced GATT (General Agreement on Tariffs and Trade) formalised in 1947. In this chapter, we shall discuss:

- GATT and multilateral trade negotiations
- Functions and organisation of WTO
- WTO agreements
- Benefits proclaimed for India
- A critical review of the working of WTO
- Singapore issues and Doha Declaration
- Hong Kong Ministerial Conference
- Bali Package
- Nairobi Ministerial Conference
- Eleventh WTO Ministerial Conference

GATT AND MULTILATERAL TRADE NEGOTIATIONS

GATT was signed by 23 countries in 1947. India was one of the founder members of GATT. Over the years the membership of GATT swelled and in 1994 touched 118 countries. GATT was all along concerned with the promotion of international trade through tariff reduction, doing away with non-discriminatory practices among trading partners, and evolving rules to counter protectionism. ***The guiding principle of GATT was what is known as the MFN (most favoured nation) clause.*** This clause says that ***"any advantage, favour, privilege or immunity granted by a contracting party to any product originating in or destined for any country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all contracting parties."*** The purpose of this clause was to discourage bilateralism and encourage multilateralism so that the world trade could expand in an orderly manner. However, formation of customs union or free trade area was allowed by GATT provided this encouraged flow of trade between the constituent territories and did not raise barriers to the trade of other member nations.

GATT provided for reduction in tariffs and trade restrictions in a phased manner over a period of time. It laid down that this task would be accomplished in different 'rounds' of trade negotiations to be held from time to time. ***In all, eight Rounds of Multilateral Trade Negotiations (MTNs) were held under the auspices of GATT***: first in Geneva (Switzerland) in 1947; second in Annecy (France) in 1949; third in Torquay (UK) in 1950-51; fourth, fifth and sixth in Geneva (Switzerland) in 1956, 1960-61 and 1964-67 respectively; seventh in Tokyo (Japan) in 1973-79; and the eighth and final round at Punta Del Este (Uruguay) in 1986-1994. Known as 'Uruguay Round', the eighth Round took more than eight years of complex negotiations as considerable differences existed among the member nations on the various issues under discussion like the questions of agricultural subsidies, Multi-Fibre Arrangement, market access, trade in services, anti-dumping, intellectual property rights etc. Because of the substantial differences among member nations on these contentious issues, the then Director General of GATT, Arthur Dunkel came up with a Draft Final Act, embodying what he thought could be the agreed outcome of the Uruguay Round. ***This was offered as a single treaty, i.e., in a form of a package — no element of the treaty could be considered as agreed unless the total package was agreed.*** Known as Dunkel Draft, it came up for intense discussion and debate in the developing countries and public opinion against signing the Draft became more and more vehement as it was felt that the Draft was heavily biased in favour of the developed countries and against developing countries, and it was so designed as to lead to a surrender of sovereign authority of the governments of developing nations. It was only after a great amount of persuasion and threats by the developed countries (particularly the USA)[1] that the governments of developing countries succumbed and on April 15, 1994, the Final Act was ultimately approved and signed. Although all member nations of GATT signed the Final Act and it appears that everything went on with "consensus of all", the fact is that most of the developing countries agreed to give their consent to the agreement to remain *integrated* with the multilateral trading

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system, otherwise they could have been isolated from the mainstream representing 90 per cent of world trade. The main concern of the developing countries has been to 'minimise the damage'. Therefore, as correctly pointed out by Muchkund Dubey, the claims regarding the benefits that developing countries have got out of the negotiations are just an attempt to 'rationalise the inevitable'.[2]

FUNCTIONS AND ORGANISATION OF WTO

The signing of the Final Act of the Uruguay Round by member nations of GATT in April 1994 paved the way for the setting up of the World Trade Organisation (WTO). An agreement to this effect was signed by 104 members. The WTO Agreement came into force from January 1, 1995 and India became a founder member of the World Trade Organisation, by ratifying the WTO Agreement on December 30, 1994 (the present membership of WTO is 164 countries). The former GATT was not really an organisation: it was merely a legal arrangement. On the other hand, ***the WTO is a new international organisation set up as a permanent body and is designed to play the role of a watchdog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights etc.*** It has the following five functions as set out in Article III:[3]

First, the WTO 'shall facilitate the implementation, administration and operation, and further the objectives, of this Agreement and of the Multilateral Trade Agreements, and shall also provide the framework for the implementation, administration and operation of the Plurilateral Trade Agreements.'

Second, the WTO 'shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreements in the Annexes to this Agreement.'

Third, the WTO 'shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes.'

Fourth, the WTO 'shall administer the Trade Policy Review Mechanism.'

Fifth, 'with a view to achieving greater coherence in global economic policy-making, the World Trade Organisation shall cooperate, as appropriate, with the International Monetary Fund and with the International Bank for Reconstruction and Development and its affiliated agencies'.

Structurally, the highest decision-making body is the Ministerial Conference, which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements. Since the coming into being of WTO in January 1995, eleven Ministerial Conferences have been held, namely Singapore (9-13 December 1996); Geneva (18-20 May, 1998); Seattle (30 November-3 December, 1999); Doha (9-14 November, 2001); Cancun (10-14 September, 2003); Hong Kong (13-18 December, 2005); Geneva (30 November-3 December, 2009); Geneva (15-17 December, 2011); Bali (3-7 December 2013); Nairobi (15-19 December, 2015) and Buenos Aires, Argentina (10-13 December, 2017).

In addition to the Ministerial Conference, there is a General Council again consisting of representatives of all the members. It itself meets as the Disputes Settlement Body (DSB) and the Trade Policy Review Body (TPRB).

Issues at Ministerial Conferences

The first Ministerial Conference held at Singapore saw the interested members of the WTO negotiating on Information Technology Agreement and the launch of work programme on the four so-called ***Singapore issues, namely (1) Relationship between Trade and Investment; (2) Interaction between Trade and Competition Policy; (3) Transparency in Government Procurement; and (4) Trade Facilitation.*** The Geneva Ministerial Conference was timed to coincide with the celebrations of the 50 years of the GATT multilateral trading system. The Seattle Ministerial Conference collapsed without being able to reach a consensus on the Declaration to be adopted by the Ministers. The Doha Ministerial Conference adopted Comprehensive Work Programme, called the ***Doha Development Agenda***, launching negotiations on some issues and setting out additional parameters and time frames for the negotiations on agriculture and services that had commenced on January 1, 2000 in accordance with the mandates in the respective WTO Agreements. The Doha Ministerial Conference also adopted a Declaration on TRIPs (Trade Related Intellectual Property Rights) and Public Health and a Decision on Implementation-Related Issues and Concerns. The fifth Ministerial Conference at Cancun was meant mainly to be a forum to review the progress of negotiations under the Doha Work Programme mandated at Doha but ended in a fiasco as serious differences emerged in the ambition levels of WTO members on the two most contentious issues, namely, Agriculture and Singapore Issues. The Sixth Ministerial Conference at Hong Kong called for conclusion of negotiations (launched at Doha) in 2006 and established time frames and targets for specific areas.

WTO AGREEMENTS

The main WTO agreements can be divided into the following categories:

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1. Agreement on agriculture.[4] This provides a framework for the long-term reform of agricultural trade and domestic policies over the years to come, with the objective of introducing increased market orientation in agricultural trade. It provides for commitments in the area of market access, domestic support and export competition. The members have to transform their non-tariff barriers like quotas into equivalent tariff measures. The tariffs resulting from this transformation, as well as other tariffs on agricultural products are to be reduced on an average by 36 per cent in the case of developed countries and 24 per cent in the case of developing countries. The reductions were required to be undertaken over 6 years in the case of developed countries and 10 years in the case of developing countries. The least developed countries were not required to make any commitment for reduction.

2. Agreement on trade in textiles and clothing (Multi-Fibre Arrangement). This provides for phasing out the import quotas on textiles and clothing in force under the Multi-Fibre Arrangement since 1974, over a span of 10 years, *i.e.,* by the end of the transition period on January 1, 2005. As a result, quotas on textiles and clothing have now been abolished.

3. Agreement on market access. The member nations are required to cut tariffs on industrial and farm goods in a bid to promote foreign trade and provide better access to foreign competitors in their domestic markets.

4. Agreement on TRIMs. The Agreement on Trade Related Investment Measures (TRIMs) calls for introducing national treatment of foreign investments and removal of quantitative restrictions. It identifies investment measures which are inconsistent with the GATT provisions on according national treatment and on general elimination of qualitative restrictions. "These are measures which impose on the foreign investors the obligation to use local inputs, to produce for exports as a condition to obtain imported goods as inputs, to balance foreign exchange outgo on importing inputs with foreign exchange earnings through export, and not to export more than a specified proportion of the local production."[5] All specific measures in the above categories being applied by any member were to be notified and eliminated in a stipulated time period.

5. Agreement on TRIPs. Prior to the TRIPs Agreement, the intellectual property rights concerning the trade (that included patents, utility models, trade marks and industrial designs) were governed by the Paris convention of 1863, which was revised up to 1967. The Paris Convention was fairly liberal and left the subject matter of patent, terms of patent and the duration of protection to be decided by the concerned national governments. The maximum divergence was observed in the case of the pharmaceutical sector where some countries protected the end product while many countries protected only the process of manufacturing and some chose to protect neither. Under these 'loose' patent laws, the trade interests of the developed countries were affected adversely. Therefore, under TRIPs (Trade Related Intellectual Property Rights) Agreement as accepted in the Uruguay Round, these countries forced the adoption of stringent conditions for the protection of the intellectual property rights (IPRs). Moreover, the scope of the Agreement was also widened to cover patents, copyrights and related rights, geographical indicators, industrial designs, layout designs of integrated circuits, and protection of undisclosed information. ***In the field of food, medicines, drugs and chemical products, the TRIPs Agreement provides for granting product patents (whereas, earlier on, process patents were used to be granted). Such product patents will be available for 20 years. In the case of copyright and related rights, protection will be available for 50 years.***

A transition period was allowed to all developing countries to give effect to the provisions of the TRIPs Agreement. The period expired on January 1, 2005. Thus, the regime of product patents has now been introduced. The Government of India adopted the Patents (Amendment) Act in March 2005 to introduce product patents in drugs and farm products.

6. Agreement on services. For the first time, trade in services like banking, insurance, travel, maritime transportation, mobility of labour, etc. was brought within the ambit of negotiations in the Uruguay Round. The GATS (General Agreement on Trade in Services) provides a multilateral framework of principles and services which should govern trade in services under conditions of transparency and progressive liberalisation. It spells out certain obligations like grant of MFN status to the other member nations with regard to trade in services, maintenance of transparency and also a commitment for liberalisation in general terms.

7. Disputes Settlement Body. Settlement of disputes under GATT was a never ending process. There was ample scope for procedural delays, objections could be raised at each stage of the dispute settlement process, and penal reports could be rejected by the offending party. The Disputes Settlement Body (DSB) set up under WTO seeks to plug these loopholes and thus provide security and predictability to the multilateral trading system. It has now been made mandatory to settle a dispute within 18 months. The findings of the disputes settlement panels will be final and binding on all parties concerned.

In addition to the above, the Uruguay Round also reached agreements on the understanding and implications of certain articles of GATT 1947, *viz.*, pre-shipment

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inspection, rules of origin, import licensing, anti-dumping measures and countervailing duties, safeguards, subsidies etc.

BENEFITS PROCLAIMED FOR INDIA

According to the supporters of WTO, India is likely to derive a number of benefits from its membership of WTO. The expected main benefits are as follows:

1. Benefits from expansion in trade. Establishment of WTO was expected to give a big push-up to international trade by reducing trade restrictions and opening up of global markets. For instance, the World Bank, OECD and GATT Secretariat had estimated that the income effects of the implementation of the Uruguay Round would add between 213 and 274 billion US dollars annually to world income. The GATT Secretariat had further projected that the largest increases would be in the areas of clothing, agriculture, forestry and fishery products and processed food and beverages. Since developing countries like India had export competitiveness in these products, they were expected to benefit considerably. For instance, the Government of India had estimated in *Economic Survey* 1994-95 that if India's market share in world exports increased from 0.5 per cent to 1 per cent and the country could take advantage of the opportunities created with the establishment of WTO, India's trade gains could amount to 2.7 billion US dollars extra exports per year (a more generous estimate could be between 3.5 to 7 billion US dollars per year).[6]

However, as pointed out by Muchkund Dubey, GATT estimates of increase in world trade were of dubious value as increase in world trade depends not only on trade liberalisation but a number of other factors like quality consciousness, proper infrastructure for export production, assured supply of export products, level of technology, etc. and India suffers from a relative disadvantage *vis-à-vis* the developed countries in most of these factors. Not only this, indulging in projection in a world full of economic and political uncertainties is a risky game, more so if the intention is "to mask reality and indulge in half truths."[7]

2. Benefits from phasing out of MFA. It was argued that the phasing out of MFA (Multi-Fibre Arrangement) by 2005 would benefit India pushing up its exports of textiles and clothings. While the developed countries had demanded a 15 year period, the developing countries (including India) had insisted on a 10 year period. Acceptance of the developing countries' demand in the Uruguay Round was enthusiastically received in these countries. However, the catch here is that the phasing out schedule favoured the developed countries as a major proportion of quota regime to the extent of 49 per cent was required to be removed only during the tenth year, *i.e.*, by 2005. Thus, ***the Uruguay Round did not provide an immediate market access for the Third World textile exports.*** This was a well thought out strategy on the part of the developed countries as this offered opportunity to countries like Portugal, Greece and Spain in the European Community and Mexico in the NAFTA block to strengthen their textile industry in the phase-out period.

3. Improved prospects for agricultural exports. The third benefit that India expected relates to the improved prospects for agricultural exports as a result of likely increase in the world prices of agricultural products due to reduction in domestic subsidies and barriers to trade. While on the one hand earnings from agricultural exports were expected to increase, on the other hand India had ensured that all major programmes for the development of agriculture remained exempted from the disciplines in the agricultural Agreement. Thus, the operation of the public distribution system would not be affected by the provisions of the Agreement; agricultural subsidies granted by developing countries could be continued till such time they remain within the prescribed limits specified in the Agreement; and protection necessary for developing the agricultural sector in the underdeveloped countries could continue. In fact, as stated above, India had hoped that the reduction of subsidies in the USA and the European Community would enable it to increase its earnings from agricultural exports.

4. Benefits from multilateral rules and disciplines. The Uruguay Round Agreement had strengthened multilateral rules and disciplines. The most important of these relate to anti-dumping, subsidies and countervailing measures, safeguards and disputes settlement. This was likely to ensure greater security and predictability of the international trading system and thus create a more favourable environment for India in the new world economic order.

A CRITICAL REVIEW OF THE WORKING OF WTO

A critical review of the working of WTO over the period of the last two decades shows that the perceived benefits to the developing countries, in general, and India, in particular, did not materialize. In fact, the 'inequality within the structure of WTO' and its bias towards the developed countries has tilted the balance in favour of these countries in all negotiations conducted so far and this bias is bound to remain in all future negotiations as well. The main disadvantages and challenges that India faces under the new international economic order are as follows:

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Inequality Within the Structure of WTO

There is extreme 'inequality within the structure' of WTO and it is this inequality that drives the outcomes, rather than any abstract notions of free trade. As noted by Subir Gokarn, "the contents of agreements are determined by the leverage that developed countries can exert over the developing countries; bribing them to agree and threatening to penalise them in other ways if they don't. Thus, the basic agreements and subsequent amendments are stacked in favour of developed countries."[8]

Two other aspects of 'inequality' also need to be pointed out. *First,* ***a single undertaking framework was adopted under the Uruguay Round of negotiations which required every country to accept all the Uruguay Round of Agreements irrespective of its level of economic development.*** Thus, the developing countries were not given additional adjustment period to bring their trade regimes in conformity with their obligations. This placed these countries at a disadvantage *vis-à-vis* the developed countries as the trade regimes of the latter were already very much in conformity with their obligations. *Second,* ***the TRIPs Agreement requires all WTO members to adhere to the same IPR (Intellectual Property Rights) standards which have already been achieved in developed countries. Thus, the effective burden of adjustment falls virtually entirely on the developing countries.***

The most disturbing aspect of the functioning of WTO is that ***the disputes settlement mechanism of WTO is by its very nature biased in favour of the rich and against the poor.*** As argued by Harish Rao, the settlement mechanism is best suited for disputes between equally strong trading partners. This is due to the reason that in case of any dispute, the WTO can only recommend retaliation by the affected member and there is no provision for collective retaliation by all WTO members against the erring member. Nor is there any provision for providing compensation to the affected member for the losses suffered.[9] In such a lopsided structure, a weak complainant may prefer to remain silent rather than retaliate against a powerful developed country.

Trade Related Intellectual Property Rights

Protection of intellectual property rights — patents, copyrights, trade marks etc. — has been made more stringent in the Uruguay Round. This has been done to protect the interests of multinational corporations and the developed countries as the Agreement on TRIPs is highly weighted in favour of the patent holders. However, as pointed out correctly by Muchkund Dubey, ***protection of IPRs (intellectual property rights) is, in itself, anti-competition and anti-liberalisation and goes against the spirit of opening up the world economy and global integration. It amounts to 'legalising' the 'monopoly' of MNCs. Thus, protection of IPRs is, itself, a barrier to trade.*** Let us now see how the Agreement on TRIPs is likely to work against India.

1. The Patent Act of India, 1970 granted only process patents to drugs and medicines. This meant that an Indian company was only required to develop and patent its own process for producing a drug, it was not required to invent the drug itself. The company could then legally manufacture this drug, even if it was protected under a product patent abroad. Finally, Indian drug companies were allowed to obtain what are called 'licences of right' which allowed them to produce, regardless of the process used, inventions (again, usually pharmaceuticals) patented abroad.

The effects of these laws have been positive for India. Indian drug prices are considered to be among the lowest in the world, and this is not at the expense of quality. In addition, the indigenous pharmaceutical industry has grown rapidly after the passage of the 1970 Act. Not only this, the market share of Indian drug companies in the local drug market went up from 30 per cent in 1970 to 61 per cent in 1993. Today, India is, in fact, an exporter of drugs to other parts of Asia, Europe, and even USA. However, the introduction of product patents from January 1, 2005 in order to meet the obligations under the TRIPs Agreement is now expected to significantly alter the equations. Although the Government of India has taken a number of steps to protect the interests of the domestic pharmaceutical companies, the latter are bound to face heat as they will not be allowed to produce drugs patented by MNCs.

2. The extension of intellectual property rights to agriculture (via the patenting of plant varieties) has serious consequences for India. In India, plant breeding and seed production are largely in the public domain. Plant breeding is undertaken by agricultural universities and units of ICAR (Indian Council of Agricultural Research), whereas seed multiplication is in the hands of the National and State Seed Corporations. This is due to the reason that India being a poor country where agriculture is the livelihood of the majority of the population, the government must bear the responsibility of ensuring the supply of adequate quantities of seeds at reasonable prices to the farmers. The aim is not to maximise profit as would be the case in the private sector, but to sustain the livelihood of the majority of the population on the one hand, and to achieve self-sufficiency in foodgrains on the other hand. ***Patenting of plant varieties will transfer all the gains to the multinational companies. Almost all new varieties will belong to MNCs simply by virtue of their massive financial resources.*** As noted by Suman Sahai, "Research is unfortunately as much a matter of talent as of money. More money means more resources

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to invest in breeding and it means greater speed in putting varieties on the market."[10] In terms of financial resources, there is absolutely no comparison between MNCs and Indian companies. In fact, the research budgets alone of some of these MNCs are more than the budget of the Indian Union. If Indian research institutions are unable to compete financially and are denied access to patented genetic material (as TRIPs Agreement is designed to ensure), the Indian scientists will find it extremely difficult to breed new varieties. This will gradually become the sole privilege of the large foreign companies. As a result, the control over our genetic resources will pass into the hands of MNCs who will not find it difficult to control the seed production in this country. Since control of seed production implies control over food supply, the entire Indian food security system could be jeopardised and thrown out of gear.[11]

3. Under TRIPs, patenting has been extended not only to plant varieties but to the large area of microorganisms as well. ***Microorganisms refer to very small forms of life.*** In this category are included such living creatures as bacteria, virus, fungus, algae (the green scum that grows near water), small plants and animals, and even genes. As argued by Suman Sahai, there are vital economic sectors that are linked to microorganisms, the most important being agriculture, pharmaceuticals and industrial biotechnology. In the field of agriculture, efforts are on worldwide to develop bio-substitutes (which are based to a large extent on micro organisms) for chemical fertilisers and pesticides as the latter are not ecologically sustainable and will poison our land and water. In the field of pharmaceuticals, several kinds of drugs are derived from microorganisms. The patenting of life forms will strike at the very roots of indigenous manufacturing of such drugs. As far as industrial biotechnology is concerned, it is estimated that in the coming two to three decades, 60 to 70 per cent of the global economy would rest on biotechnology because this is perhaps the most versatile of all the technologies that we have seen so far.[12] ***Patents in all the three fields (agriculture, pharmaceuticals and industrial biotechnology) linked to microorganisms are either already with the multinational companies or are likely to be acquired at a much faster rate vis-à-vis the developing countries.*** Thus multinational companies belonging to the developed countries are likely to dominate the 'global' economy that will emerge in the coming years.

Trade Related Investment Measures

According to Muchkund Dubey, the developed countries achieved almost everything they wanted from the TRIMs Agreement. In order to make the Agreement balanced from the point of view of the developing countries, it was necessary to formulate international rules for controlling restrictive business practices of foreign investors. However, the TRIMs Agreement is totally silent on this vital question and is concerned mainly with provisions for elimination of trade related investment measures which are designed to protect the interests of foreign investors in the developing countries. Of course, the developing countries have been allowed to deviate from the provisions of TRIMs Agreement on balance of payments ground. However, once there is an improvement in the balance of payments, the host country is required to eliminate the identified measures even if there is justification to maintain them on broader macroeconomic and strategic considerations. When applied to the developing countries, the provisions of the TRIMs Agreement will most likely have the effect of undermining any plan or strategy of self-reliant growth, based on the technology and other resources available locally. It could also prove a drain on the foreign exchange reserves of the developing countries, adversely affecting their balance of payments position. Moreover, as correctly pointed out by *Tenth Five Year Plan*, the multinational framework cannot guarantee an increase in FDI (Foreign Direct Investment) inflows, although it could impact the quality of the inflows.[13]

Competition in Services (GATS)

There is a vast level of difference in the development of services like banking, insurance, telecommunications and shipping as between the developed countries and the developing countries. Therefore inclusion of trade in services is bound to benefit developed countries much more than the developing countries like India. In fact, the very inclusion of trade in services in Uruguay Round negotiations was on persistent insistence of the developed countries who have all along been arguing that opening up of trade in services is an important requirement for globalisation and development of world trade. The principal exporters of services are the developed countries. Therefore, they are expected to benefit more with the opening of the trade in services.

As far as India is concerned, it has a large reservoir of highly skilled and experienced professionals like engineers, doctors, scientists, computer and software experts. Thus, free movement of natural persons would be to its benefit. However, movement of natural persons has been restricted by many of the developed countries.[14]

Trade and Non-Tariff Barriers by Developed Countries

Contingency trade policy measures and non-tariff measures (NTMs) continue to act as significant barriers to exports from developing countries. ***Such barriers are considerably stiffer for products with lower value addition***

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and lower technological content (for example, agriculture, textiles, and leather products), which are of major interest to developing countries like India. Despite the provision under the various agreements and ministerial decisions for eliminating or disciplining non-tariff barriers (NTBs), they continue to be largely non-transparent, *ad hoc* and complex. While direct NTBs (such as quantitative restrictions, tariff quota, voluntary export restraints, orderly marketing arrangement, export subsidy, export credit subsidy, government procurement and import licensing, etc.) are explicitly designed and implemented for purposes of restricting trade, indirect NTBs (such as health and safety regulations, technical standards, environment control, customs valuation procedures, rules of origin, labour laws, anti-dumping duties, countervailing duties, regional subsidisation and subsidisation of public enterprises etc.) are notionally implemented to meet some other policy target but affect the trade flows in the process. While some NTBs are genuine, others are intended to restrict imports, insulating domestic producers from the effect of world prices. Of late, the nature of NTBs is changing with declining importance of traditional NTBs and growing importance of knowledge-based NTBs embodied in SPS (sanitary and phyto-sanitary) and TBT (technical barriers to trade).

A significant proportion of exports of developing countries like India is affected by single or multiple NTBs imposed by developed countries on account of health safety, environmental and other concerns. ***Indian exports, in general, face NTBs relating to (i) packaging and labeling regulations, (ii) standards, (iii) uniformity requirements, (iv) labour standards, (v) documentation and related procedures, and (vi) company and product registration.***[15]

Agreement on Agriculture[16]

Tenth Five Year Plan noted a number of issues of concern as far as Agreement on Agriculture (AoA) is concerned:[17] (1) ***AoA has legitimised the various trade distorting practices of the developed countries in their favour;*** (2) AoA provides that countries not using any subsidies during the period 1986-88 (which has been identified as the 'base period' for Agreement) are prohibited from introducing any new subsidies in the WTO regime. This automatically places a small number of rich countries, which have been using export subsidies, in an advantageous position as they have been provided the opportunities to use these subsidies (as noted by the Tenth Plan, while developed countries are allowed to retain 80 per cent of their subsidies, the developing countries can subsidise their farmers not more than 10 per cent of the total value of agricultural production); (3) ***about 40 to 50 per cent of support to farmers in USA and EU is in the form of Green Box and Blue Box subsidies and are thus exempted from reduction commitments.***[18] India and other developing countries have objected to this and have argued that in the absence of specific discipline to ensure that farmers do not divert payments received for non-trade distorting objective to production boosting investments, all subsidies can distort trade; and (4) the peak tariff on agricultural commodities in developed countries is very high. For example, one-fifth of the peak tariff of the USA, a quarter of those of EU, about 30 per cent of those of Japan and about one seventh of those of Canada exceed 30 per cent. It has also been observed that the most important areas for developing countries face highest tariff rates and include the major agricultural staple foods, cereals, meat, sugar, milk, butter and cheese as well as tobacco and cotton. Moreover, tariff wedges will continue to be significantly high on account of tariff escalation, which is a major factor preventing developing countries from diversifying and increasing their share of processed agricultural exports.

An issue of specific concern to the developing countries is the issue of food security. The AoA does not address itself adequately to this question and there is a line of thinking that views trade as providing the means for food security in these countries. This assumes that the existence of global surpluses of foodgrains would enable the developing countries to meet their food needs. This is described as food security 'by way of trade view'. According to this view, it is not necessary for developing countries to target food self sufficiency as global surpluses would enable these countries to meet their food needs. However, as correctly pointed out by Biplab Dasgupta, this view is based on the following assumptions: *(i)* the global trade is so integrated that it is possible for any country to buy anything from any market, at a price ruling in that market; *(ii)* every country in the world makes production decisions on the basis of its 'comparative advantage', and imports the other required commodities from the integrated world market; *(iii)* non-economic factors, such as the needs for diplomacy or war do not influence the production and export-import decision of a country; and *(iv)* both the rich and the poor countries adhere to such rules of global trade.[19] Each of these assumptions is erroneous. Moreover, food security 'by way of trade view' is based on the belief that developing countries have sufficient foreign exchange at all times to meet their food import requirements. This, again, is not true. Accordingly, food self-sufficiency should remain the cornerstone of the food security system of the developing countries.

Labour Standards and Environment

Two very sensitive issues from the point of view of the developing countries are the issues relating to labour standards and environment. The developed countries tried

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to force these issues in the Seattle meeting held in Seattle, Washington, from November 29 to December 3, 1999. As far as the issue of labour is concerned, there are two points that have been highlighted by the developed countries. The first relates to core labour standards and the second to child labour. Developed country trade unions are in the forefront of the demand for linking trade with labour standards. What drives them, of course, is not international solidarity with the workers in the developing countries but the desire to protect their own jobs. They fear that globalisation of trade will lure investments away from the industrialised world to poor countries where wages are low. However, asking for the wage levels in developing countries to be raised to the levels that obtain in the developed countries is a highly obnoxious demand. By the same token, India and other developing countries can demand the raising of capital costs (interest rates) in developed countries to the levels that prevail in their economies. As far as the question of child labour is concerned, the demand that children should go to school rather than work is, in itself, a fair demand. But it ignores the realities of the poor countries. Children in these countries are sent to work because their families are too poor to send them to school. Barring children from work will not mean that they will start going to school from the next day. If anything, the loss of income will mean a further setback for their already poor families.

The fact of the matter is that child labour is prevalent in developed countries such as the USA, UK, Italy, Portugal and Spain as well. However, developing countries are not in a position to take trade measures against them.

As far as the question of linking trade with environment is concerned, this is again undesirable from the point of view of the developing countries. As argued sometimes back by Jagdish Bhagwati, when it came to environmental standards, poor countries where dysentery is a major killer, might want to spend money on improving the quality of drinking water rather than on cleaning up automobile pollution. Linking trade to the quality of ambient air might force poor nations to divert resources from water quality to air pollution, and might actually reduce global well-being.

Trespassing the Sovereignty of Nation-States

WTO has been granted powers to enact international laws on matters that were under national jurisdiction earlier. The GATT agreement was concerned only with issues relating to international trade. No attempt was made to interfere in the sphere of autonomous decision-making of its member States. The nation-States could have their own laws relating to the protection of patents, trade marks and copyright; conservation of exhaustible natural resources; restrictions on export of domestic materials; laws and regulations essential for the acquisition or distribution of products in short supply etc. The WTO Agreement, in contrast, 'annexes' vast spaces of national decision-making into its domain. As noted earlier, the entire spectrum of intellectual property rights (IPRs) has been lifted out of the national domain and subjected to a rigorous international discipline. The trade in services has been defined in an open-ended manner so as to bring within the ambit of GATS (General Agreement on Trade in Services), any and every possible activity except the essential law making, policing and judicial functions of the State. The national investment regimes will similarly be subject to the international discipline as laid down under TRIMs. The developed countries are also trying to bring other issues like social clauses, labour services and issue of child labour, environmental protection, etc. under the new international control regime.

The above discussion shows that ***the WTO trespasses the sovereignty of nation-States. Under the guise of 'rule based multilateral order', 'global integration' and 'development of free international trade', the developed nations have succeeded in building up a new international economic order that fully serves their interests and sacrifices the interests of the large, silent and deprived majorities of the developing countries.***

SINGAPORE ISSUES AND DOHA DECLARATION

Singapore Issues

Ever since the inception of WTO, the developed countries have been pressurising for expansion of negotiating agenda. This was clear at the first ever Ministerial Conference held in Singapore in 1996 itself where these countries demanded that the negotiating mandate of WTO be broadened to include trade and investment, trade and competition policy, government procurement, trade facilitation, labour standards and environmental standards. Having undertaken heavy commitments in the just concluded Uruguay Round, developing countries resisted these demands. They managed to put labour standards and environment off the WTO agenda for the time being. On the other four issues, *viz.*, ***(i) investment, (ii) competition policy, (iii) government procurement, and (iv) trade facilitation***, as a compromise measure, Working Groups were set up to conduct study processes without any negotiating mandate. ***These four issues have come to be known as 'Singapore Issues.'*** On all these four issues there are considerable differences of opinion not only between developed and developing countries but even amongst the developed countries themselves. Debates at the Working Groups over the past two decades

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have failed to produce a consensus and establish conclusively the need for binding rules.

Developing countries like India have argued that all the four issues mentioned above have a strong development dimension which a focused organisation like the WTO is not competent to handle. In particular, these countries have opposed the Singapore issues on the following grounds: (1) there is no single accepted view on various elements of 'investment' including scope and definition, transparency, dispute settlement, performance requirement etc.; (2) the need for a multilateral agreement on investment itself is not clear. Although it can neither promise additional investment flows nor reduce transaction costs for investors significantly, such agreement will certainly curtail the policy space of developing countries; (3) government intervention is necessary to ensure that foreign direct investment (FDI) is guided by the overall policy goals and has a positive developmental impact; (4) given the little experience that developing countries have in dealing with competition policy even at the national level, it is premature to consider a multilateral framework; (5) it is necessary to clearly define the various elements of 'competition' such as core principles, cooperation mechanisms, coverage and prohibition of hard-core cartels etc., before the developing countries can agree to any multilateral discipline in this regard because these countries have genuine development concerns in implementing competition policies; (6) multilateral rules, binding in nature, regarding transparency in government procurement are likely to take away valuable development policy space from governments; (7) just as in the case of transparency in government procurement, there is no rationale for binding rules in the case of trade facilitation either. Technical assistance and autonomous policy decisions should be preferred over binding rules which will put heavy burden of compliance on developing countries; and (8) any agreement on trade facilitation would benefit the developed countries more as it is these countries that export 80 per cent of the goods imported by the developing countries.

Because of considerations such as these, Singapore issues emerged as a bone of contention between the developed and the developing countries first at the Doha meeting in 2001 and then at Cancun meeting in 2003. ***Because of their reluctance to reduce agricultural subsidies and provide more market access in their agriculture to developing countries, the developed countries took cover behind the Singapore issues resulting in a breakdown of all negotiations.***

Doha Declaration

As stated earlier, the trade ministers of WTO members meet once in two years and this is known as the Ministerial Conference. While preliminary work goes on at the Geneva headquarters of WTO with members providing key inputs, key decisions are taken at the Ministerial Conference. The Fourth Ministerial meeting was held at Doha (Qatar) in November 2001. The main features of the Doha Declaration (also known as ***Doha Development Agenda***) signed by the member countries were as follows:

1. Launch of a New Round of Negotiations. Before the Ministerial meeting at Doha began, the Government of India had adopted the "implementation before expansion" position. Many other developing countries had also supported India's position as they felt that the trade regime had not delivered on its promises to them. However, under pressure from the developed countries, the Doha Declaration announced the launch of a new round of negotiations. This was termed the Doha Round.

2. TRIPs and Public Health. The major success claimed by the developing countries (particularly India) was in the field of TRIPs and public health. The separate declaration adopted on the issue stated that the "TRIPs Agreement does not and should not prevent members from taking measures to protect public health." For this, it says that "the Agreement can and should be interpreted and implemented in a manner supportive of WTO members' right to protect public health and in particular, to promote access to medicines for all." In other words, the Declaration made it clear that ***any member of the WTO has a right to knock off patents on pharmaceutical products on public health grounds.*** As far as countries without manufacturing capacities are concerned, there was a statement that said that such countries could grant a compulsory licence to a company in some other developing country which possesses the necessary capacity.

3. Agricultural Subsidies. Although seven years had elapsed since the conclusion of the Uruguay Round, the developed countries had failed to meet their commitments with regard to the reduction in agricultural subsidies. In fact, the USA and the European Union (which are the two biggest agriculture exporters) sharply increased their agricultural subsidies instead of reducing them. As a result, prices of all the major agricultural commodities suffered a secular decline. This left low-cost producers like India in a quandary as international prices in most of the commodities were well below their domestic prices.

In view of the above, ***the Doha Declaration specifically stated that the mandated negotiations would aim at "substantial improvements in market access; reduction of, with the aim of phasing out, all forms of export subsidies; and substantial reduction in trade-distorting domestic support."*** The Declaration also recognised the

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importance of non-trade concerns like food security and rural development for developing countries. Thus, countries like India which have a strong public distribution system could continue to retain it and, in addition, could also provide greater domestic support to the rural economy.

4. Market Access for Industrial Products. The Declaration agreed to negotiations which was to aim, by modalities to be agreed, to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries. Product coverage was to be comprehensive and without *a priori* exclusions.

5. Environment and Labour Issues. In order to get the benefits of reduction in export subsidies for agricultural goods in the developed countries, the developing countries had to make a trade-off with environment. Thus, they agreed to negotiations on environmental issues. However, they succeeded in preventing negotiations on labour issues by arguing that these issues are best left with the International Labour Organisations (ILO).

6. Special and Differential Treatment (S&DT) Provisions. The Special and Differential Treatment (S&DT) provisions in GATT were incorporated following the recognition of inherent inequality between players in the multilateral trading system and the special needs and development concerns of the developing countries. However, the Uruguay Round considerably diluted the S&DT provisions. From enhanced market opportunities to developing countries, the Uruguay Round Agreements shifted thrust to transition periods and technical assistance. Even these new provisions were not legally binding and did not go beyond best endeavour clause. On a joint submission by 12 developing countries to the General Council of WTO in September 2001, ***the Doha Ministerial Conference reaffirmed that S&DT provisions are an integral part of the WTO Agreements*** and agreed that all S&DT provisions 'shall be reviewed with a view to strengthening them and making them more precise, effective and operational.'

7. Singapore Issues. As stated earlier, in the first Ministerial Conference held in Singapore, it was agreed that the issues of investment, competition policy, government procurement, and trade facilitation would merely be 'studied' and there was no negotiating mandate. However, the matter came to a head at Doha when the Ministers were launching a new round of multilateral trade negotiations with developed countries (particularly countries of the European Union and Japan) insisting on their inclusion in negotiations. However, developing countries under the leadership of India were able to thwart their efforts. A compromise was struck under which it was recognised that while there is a need for negotiations in these areas they could begin only after there was 'explicit consensus' at the Fifth Ministerial Conference to be held at Cancun on the 'modalities of negotiations.'

The Doha Agenda negotiations had a tightly sequence agenda. Thus, members had to finalise the results of the package of issues contained in S&DT provisions by the end of July 2002, the TRIPs and public health agreement by December 2002, agriculture negotiating modalities by March 2003 and industrial negotiating framework by end-May 2003, and so on. None of these deadlines could be met, in some cases even after the extension of deadlines. The first spanner in the Doha works came in July 2002 when the General Council failed to complete the work on S&DT issues, giving room for developing countries to point an accusing finger that the developed countries were not prepared to address issues of concern to developing countries. As far as TRIPs and public health issue is concerned, USA played the spoilsport when it single-handedly blocked the proposal of the other 145 members on December 20, 2002 for distributing patented medicines to less developed nations. While representatives of 145 countries pressed the broader view that any 'public health problem' could justify overriding patents, USA stuck to its stand that patent exception could apply only to epidemics such as AIDS, tuberculosis and malaria. As far as the issue of market access in agriculture is concerned, most of it has been provided by the developing countries in the post-Uruguay phase. The developed countries have tended to either under-implement their commitments or to implement them in a manner that makes the fruits of liberalisation unavailable to the developing countries. ***Developed countries continue to provide significant domestic support to agricultural production alongwith substantial export subsidies.*** In fact, agricultural subsidies by OECD countries (known as producer support estimate or PSE) increased from $ 241 billion during 1986-88 to $ 257 billion in 2003 which was as much as 32 per cent of the value of their agricultural output.[20] In fact, according to *Human Development Report* 2005, ***"The problem at the heart of the Doha Round negotiations can be summarised in three words: rich country subsidies".***[21]

HONG KONG MINISTERIAL CONFERENCE

Hong Kong Ministerial Declaration

The Sixth Ministerial Conference was held at Hong Kong from December 13 to 18, 2005. The Ministerial Declaration adopted at the end of the Conference called for conclusion of negotiations launched at Doha in 2006, and

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Box 43.1

Key Outcomes and Timelines of Hong Kong Ministerial Declaration

- Resolve to complete the Doha Work Programme fully, and to conclude negotiations in 2006.
- To establish modalities in agriculture and non-agricultural market access (NAMA) by April 30, 2006 and prepare draft schedules by July 31, 2006.

Agriculture

- Agricultural export subsidies to be phased out by the developed countries by 2013.
- However, domestic support would continue implying that agricultural output of the developed countries would still be subsidised.
- On grounds of food security, livelihood security and rural development needs, developing countries will be able to self-designate 'Special Products' which will attract more flexible tariff reduction treatment.
- Speical Safeguard Mechanism (SSM) for developing countries.
- For cotton, export subsidies will eliminatedted by developed countries in 2006.

Non-Agricultural Market Access

- The Hong Kong Declaration seeks to achieve the objective of reduction or elimination of tariffs, including tariff peaks, high tariffs and tariff escalation.
- It has been agreed that tariffs would be brought down according to the "Swiss Formula" (this formula proposed by Switzerland is given as follows

$$T_t = \frac{a \times t_0}{a + t_0}$$

where T_t is the final rate to be bound in *ad valorem* terms, t_o is the base rate, 'a' is a coefficient whose value determines how deep the tariff cuts will be.

This formula results in deeper cuts on higher tariffs and milder cuts on lower tariffs.

Less than Full Reciprocity

- Developing countries would sacrifice less than the developed countries. All cuts and concessions offered by developed nations will be reciprocated by developing countries in a lesser measure. This clause would also give the developing countries a larger phase-out time to integrate themselves into the multilateral trading system.

Services

- On the services front not much progress was made. However, the members were asked to submit a second round of revised services' offers by July 31, 2006 and submit final draft schedules by October 31, 2006.

TRIPs

- Amendment to TRIPs Agreement reaffirmed to address public health concerns of developing countries.

Development

- Least developed countries will be guaranteed duty-free, quota free access for 97 per cent of their exports from 2008, or from not later than the coming into effect of any final trade treaty.

established time frames and targets in specific areas (see Box 43.1).

A Critical Appraisal

The outcome of the Hong Kong Ministerial Conference was, at best, modest. The initial hopes were that the Conference would mark the penultimate stage in the Doha round by facilitating a long-delayed agreement on modalities (the structure and tariff-reduction formulae) of trade liberalisation in agriculture and industry (non-agricultural market access or NAMA). But when it became clear that differences in the 'three core' areas (agriculture, industry and services) had not been narrrowed, "expectations were lowered" so that the Ministerial would not end in open disagreement. Thus, the only important achievement was that the Ministerial did not flop.

At Hong Kong Ministerial, WTO Ministers had agreed to establish modalities for agriculture and Non-Agricultural Market Access (NAMA) by April 30, 2006, submit the Draft Schedules by July 31, 2006 and conclude the negotiations across all areas of the Doha Round by the end of 2006. In respect of services, all Members were to file their revised offers by July 31, 2006 and submit the Draft Schedules by October 31, 2006. These deadlines were missed despite intensive negotiations over the period January 2006 to July 2006 wherein main focus was on the triangular issues of Domestic Support, Agricultural Market Access (AMA) and Non-Agricultural Market Access (NAMA). Hectic negotiations were held and efforts were first made to establish the modalities by June 30, 2006. An informal meeting of 31 Trade Ministers, including from India, was convened by the Director General, WTO, Pascal Lamy, in

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Geneva between 29 June and 1 July, 2006 but without any success. Efforts were then made to establish the modalities by July 31, 2006. A meeting of the G-6 WTO Ministers (from Australia, Brazil, European Union, India, Japan and the United States) was held in Geneva on July 23 and 24, 2006 but there was no convergence on the core issues of substantial reduction of trade-distorting support and other development issues. Following detailed consultations, the DG, WTO convened an informal meeting of the WTO Trade Negotiations Committee (TNC) on July 24, 2006. The DG reported that "it remained clear that the gaps remain too wide", and recommended that the only course of action would be to suspend the negotiations across the Round as a whole to enable serious reflection by participants. ***In the light of the impasse particularly in agriculture and ruling out the possibility of finishing the Round by the end of 2006, Members agreed to suspend the negotiations across all areas of the Doha Work Programme***, and to resume them when the negotiating environment was right.

After the suspension of negotiations in July 2006 due to wide gaps in the positions of WTO members, especially on agricultural domestic support and market access, there was a soft resumption of negotiations on November 16, 2006. Subsequently there was full-scale resumption of negotiations on February 7, 2007, on the principles that it preserves the architecture of the negotiations, inclusiveness, and the progress made so far, and leads to an outcome that is balanced, ambitious and pro-development.

In July 2008, the WTO director general Pascal Lamy convened a meeting of trade ministers of seven countries (USA, the EU, Japan, Brazil, India, Australia and China) — christened the G-7— to finalise the modalities (benchmarks) in the two areas of agriculture and market access for industrial goods (non-agricultural market access or NAMA). All the other elements of the detailed agenda of the Doha Round were put in abeyance. Notwithstanding that the Doha Round is a "single undertaking", which means that nothing is decided until everything is agreed to, the WTO director general adopted this controversial route to satisfy Washington. However, even on these two issues, no deal could be struck as the differences over the benchmarks in both agriculture and industrial goods remained very wide.

BALI PACKAGE

The Ninth WTO Ministerial meeting was held in Bali, Indonesia, from December 3 to December 7, 2013. The meeting adopted the 'Bali Package', a deal designed to streamline trade, allow developing countries more options for providing food security, boost least developed countries' trade and help development more generally. The two main agreements in the Bali package concern: (1) food subsidies, and (2) trade facilitation. India played a key role as far as protecting food subsidies is concerned, by placing the need for ensuring food and livelihood security of millions of poor people at the heart of the trade talks. Existing rules capped the value of food subsidies at 10 per cent of the value of production. But the way the support is calculated at prices of more than two-decades ago (1986-88 prices) means that countries would find it more and more difficult to stay within the limit, potentially attracting strong penalties from the trade body. India led the effort to allow subsidies without penalties even if this cap is breached. Much of the focus was on shielding public stockholding programmes in developing countries, so that they would not be challenged legally even if a country's agreed limits for trade-distorting domestic subsidies were breached. In the end, India successfully lobbied for allowing developing countries to continue with food subsidies without attracting penalties till a permanent solution is agreed upon. According to the decision, members agreed to "put in place an interim mechanism" and "negotiate on an agreement for a permanent solution" for the issue of public stockholding for food security purposes for adoption by the 11th Ministerial Conference. In the interim, till a permanent solution is found, countries were not to file disputes against the developing countries that exceed the level of subsidy that is allowed under the WTO rules. This means that India could continue with its food security programme without attracting penalties. However, this concession was to be available for four years only (till the 11th Ministerial) and the position beyond this period was left unclear.

The second major agreement was on trade facilitation. This agreement made it mandatory for member countries to cut red tape for easier movement of goods. The objectives are to speed up customs procedures; make trade easier, faster and cheaper; provide clarity, efficiency and transparency; reduce bureaucracy and corruption; and use technological advances. It also has provisions on goods in transit, an issue particularly of interest to landlocked countries seeking to trade through ports in neighbouring countries.

The 'Bali package' is the first ever trade reform deal agreed upon by the member countries of WTO after it was set up in 1995. However, the July 31, 2014 deadline for adopting TFA (Trade Facilitation Agreement) was missed as India refused to sign the TFA unless it is bundled with a roadmap for rules on food subsidies. India believes that progress on TFA has been quicker (as it serves the interests of the developed countries better) than over its proposal on food security — a departure from WTO's practice of 'single undertaking', under which all parts of an agreement

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move together. Accordingly, India's ambassador at WTO, Anjali Prasad put out India's final stand before the WTO's General Council on July 25, 2014 holding that the Bali outcomes were negotiated as a package and must be concluded as such. After many notes were exchanged and options discussed, finally on July 30, 2014 India proposed two options. First, that the Article 18.4 of the Agreement on Agriculture should be explained or the 1986-88 price reference for calculating subsidies should be updated. Article 18.4 talks about inflation adjustment to domestic price support given by countries to their farmers. Second, the 'peace clause' under which India has a four-year relief during which no country can challenge it at the WTO if it violates the food subsidy limits should be extended till a permanent solution is found.

Special General Council Meeting. A 'special' meeting of the WTO General Council (the highest decision-making body after Ministerial Conferences) was convened at Geneva on November 26, 2014 to resolve the dispute. Following tense negotiations and last-minute hiccups due to opposition from Argentina and Pakistan, the General Council adopted three main decisions – (*i*) signing of the TFA protocol, (*ii*) ***extension of 'peace clause' for an indefinite period till a final solution to the issue of food stockholding is found,*** and (*iii*) setting a deadline for the remaining Bali package commitments for poorer countries.

While India has been able to ensure 'perpetual' peace clause, this concession does not come free. India, alongwith other developing countries, have to adhere to some strict conditions to avail of the interim relief. The most important rider pertains to future food stockholding programmes, which would not be covered under this provision. In other words, any new food stockholding programme will have to follow WTO's 10 per cent threshold. Another condition is that countries following food stockholding programmes will have to ensure they do not distort trade and adversely affect similar schemes of other developing countries. Otherwise, the affected country will have the option of appealing to the WTO dispute settlement body.[22]

NAIROBI MINISTERIAL CONFERENCE

The WTO's Tenth Ministerial Conference was held in Nairobi, Kenya, from December 15 to 19, 2015. It culminated in the adoption of the ***Nairobi Package,*** a series of six Ministerial Decisions on agriculture, cotton and issues related to least-developed countries. The main contents of the Nairobi Package are presented in Box 43.2.

A Critical Appraisal

The most serious failure of the Nairobi Ministerial Declaration was its inability to 'reaffirm' a commitment to the Doha Development Agenda (DDA). While agreeing to continue deliberations on the Doha agenda along established lines, the declaration indicated that not everyone was willing to do so. In other words, the consensus – recall that the WTO operates on this principle, not on majority rule – was that no consensus was possible. In other words, DDA is dead for all practical purposes. Not only this. The Declaration notes that "new approaches are necessary to achieve meaningful outcomes in multilateral negotiations". This means that the US-led developed countries will now be able to introduce issues of their choice so far resisted by the developing countries (for example, the three issues – investment, competition, and transparency in government procurement).

As far as India is concerned, of the six items of the Nairobi package, two were of particular interest to it – a permanent solution to the issue of public stockholding for food security and Special Safeguard Mechanism (SSM) to protect farmers from import surges. As far as the former is concerned, as stated earlier, India had agreed to sign the TFA protocol in November 2014 on condition that the 'peace clause' is extended for an indefinite period till a final solution to the issue of food stockholding is found. The Nairobi package has merely reiterated this statement. Thus, ***the peace clause continues but there is no effort to sort out the issue.*** As far as the latter issue is concerned, the Nairobi package recognised developing countries' right to have recourse to an SSM. However, the recognition does not guarantee an SSM as creation of SSM is still subject to future negotiations in dedicated session of the CoASS.

One ministerial decision that is extremely detailed relates to export competition and it sets out conditions for provision of subsidies and credits for agricultural exports. On the face of it, this favours developing countries which get time till end 2018 (in some cases upto end 2023) to eliminate their export subsidies while developed countries have to eliminate theirs immediately. But experts on agricultural negotiations insist that the Ministerial decision is riddled with provisions that give a lot of flexibility to the developed countries and reduce flexibilities to the developing countries.

As noted by D. Ravi Kanth, before the commencement of the Nairobi Ministerial, India was expected to settle for a trade-off. The trade-off involved securing a permanent solution to public stockholding programmes for food security and SSM, and reaffirmation to continue the DDA negotiations

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Box 43.2

Nairobi Package

Agriculture

- **Special Safeguard Mechanism for Developing Country Members.** The developing countries will have the right to have recourse to a special safeguard mechanism (SSM) and negotiations on this issue shall be pursued in dedicated sessions of the Committee on Agriculture in Special Sessions (CoASS). It was further resolved that the General Council shall regularly review progress in these negotiations.
- **Public Stockholding for Food Security Purposes.** Members shall engage constructively to negotiate and make all concerted efforts to agree and adopt a permanent solution on the issue of public stockholding for food security purposes. In order to achieve such permanent solution, the negotiations on this subject shall be held in CoASS, in dedicated sessions and in an accelerated time-frame, distinct from the agriculture negotiations under the Doha Development Agenda.
- **Export Competition.** Developed members shall immediately eliminate their remaining scheduled export subsidy entitlements as of the date of adoption of this decision. Developing country members shall eliminate their export subsidy entitlements by the end of 2018. However, certain benefits under Agreement on Agriculture shall continue for developing countries till 2023 (i.e., five years after the end-date for elimination of all forms of export subsidies) while least developed countries and net food-importing developing countries shall continue to have such benefits till 2030.
- **Cotton.** Cotton and cotton-related products originating from least developed countries shall be provided duty-free and quota-free market access by developed country members and developing country members (declaring themselves to be able to do so) from January 1, 2016.

LDC Issues

- **Preferential Rules of Origin for Least Developed Countries.** The Nairobi package has announced a number of measures to ensure that preferential rules of origin applicable to imports from LDCs are transparent and simple, and contribute to facilitating market access.
- **Implementation of Preferential Treatment in Favour of Services and Service Suppliers of LDCs and Increasing LDC Participation in Services Trade.** The Nairobi package has extended the preferential treatment to specified services provided by LDCs until the end of 2030. In addition to this, members shall give special priority to addressing regulatory barriers of interest to LDCs.

  Moreover, with a view to further increasing LDC participation in services trade, members are encouraged to undertake specific technical assistance and capacity building measures to orient LDC service suppliers to preference benefits available so that such suppliers can utilize the preferences granted.

beyond Nairobi. In return, it would continue to a substantive agreement on export competition entailing a phase-out of export subsidies and reducing export credits. "In the final analysis, it is clear that India failed in its objectives to secure credible outcomes on its demands for SSM, permanent solution for public stockholding programmes for food security and the reaffirmation to continue the DDA negotiations. Perhaps, ***this is the first time that India left a WTO ministerial meeting so diminished".***[23]

ELEVENTH WTO MINISTERIAL CONFERENCE

The WTO's Eleventh Ministerial Conference was held in Buenos Aires, Argentina, from December 10 to 13, 2017. There was no agreement at the Conference on the multilaterally mandated issues. These include: *(i)* the permanent solution for public stockholding programmes for food security; *(ii)* the work programme on special safeguard mechanism (SSM) for developing countries to curb unforeseen surges in imports of agricultural products; *(iii)* the work programme on agreement-specific proposals for improvements in special and differential flexibilities; *(iv)* the long-standing cotton issue since the 2005 Hong Kong Ministerial Conference; and *(v)* a Ministerial Declaration which is the hallmark of a successful Ministerial Conference.[24] Consequently, the chair of the Conference, Susana Malcorra, merely issued what is called the 'Chair's Statement', which has no legal bearing, and for all practical purposes, the mandated issues stay in their respective places. ***The main reason for the collapse of the Conference was the stubborn attitude of USA on the issue of finding a permanent solution to the food stockholding issue.*** Without naming the USA, a Commerce Ministry statement on December 12, 2017 said India is "surprised and deeply disappointed" that despite an overwhelming majority of members reiterating for a permanent solution "a major member country has reneged on a commitment made two years ago to deliver a solution of critical importance for addressing hunger in some of the poorest countries of the world". With the US President Donald Trump pitching for

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an 'America First' trade policy, this was not unexpected. ***Many critics allege that the US is bent upon wrecking the multilateral framework of the WTO and is pushing for plurilateral sectoral agreements in which the large majority of developing and least developed countries that have become vocal and assertive can be excluded from negotiating multilateral trade rules.***

After the US blocked a permanent solution on government stockholding for food security purposes, India toughened its stand on new issues including e-commerce and investment facilitation. India also blocked a draft ministerial decision on "policy dialogue" that was initiated to bring new issues such as gender and trade, labour and trade, and environment into international trade on the grounds that it was not a part of the WTO mandate. However, member nations did manage to secure a deal on elimination of fisheries subsidies by the next ministerial in December 2019. They also committed to improve the reporting of existing fisheries subsidy programmes. In addition, members took some other decisions including extending the practice of not imposing customs duties on electronic transmissions for another two years, and they committed to continue negotiations in all areas.

Plurilateral Push. As the meeting was collapsing on all major fronts, developed countries led by the US and the European Union sought to find a way out of the deadlock by forming large pressure groups on e-commerce, investment facilitation and MSMEs (micro, small and medium enterprises) within the WTO with more than 70 members in each formulation. Though WTO is driven by consensus and even a plurilateral agreement needs approval of all members, analysts see the formation of these groups as an attempt to steer WTO away from its focus on multilateralism. Although discussions on the above issues cannot be held under the WTO's mandate, plurilateral proponents can convene informal meetings on these issues that have no bearing on the regular work of the WTO. As pointed out by D. Ravi Kanth, they will now create two negotiating engines at the WTO: "While the work on the mandated multilateral issues such as the permanent solution for public stockholding programmes will proceed at a halting speed given the opposition from the US and other countries, work on the plurilateral initiatives will be intensified to create a miasma that multilateral outcomes on developmental trade issues have no future."[25]

NOTES

1. As noted by Muchkund Dubey, by the time the Uruguay Round was launched, more than half of the developing countries had become dependent on developed countries and on the IMF and the World Bank on their behalf, for repeated rescheduling of their debts. The developed countries fully exploited this vulnerability of the developing countries and succeeded in breaking their unity. The United States also pressurised developing countries by using Super and Special 301 measures against them. See Muchkund Dubey, *An Unequal Treaty: World Order After GATT* (New Delhi, 1996), p. 5.
2. *Ibid.*, p. 10.
3. Bibek Debroy, *Beyond the Uruguay Round: The Indian Perspective on GATT* (New Delhi, 1996), p. 42.
4. For a detailed discussion on Agreement on Agriculture, please refer to the section 'WTO and Indian Agriculture: Challenges and Prospects in the Global Economy' in the chapter on "Issues in Indian Agricultural Policy and Development."
5. Muchkund Dubey, *op. cit.*, p. 69.
6. Government of India, *Economic Survey* 1994-95 (Delhi, 1995), p. 99.
7. Muchkund Dubey, *op. cit.*, pp. 14-5.
8. Subir Gokarn, "Guilty Until Proven Innocent", *Business Standard*, August 23, 1999, p. 11.
9. Harish Rao, "At the WTO, Might is Very Often Right", *Business Standard*, September 20, 1999, p. 10.
10. Suman Sahai, "American Pressure to Open Up Indian Agriculture", *Economic and Political Weekly*, February 24, 1996, p. 443.
11. Some of the issues discussed here have been addressed in the Protection of Plant Varieties and Farmers' Rights Legislation passed by the Parliament in August 2001. For details, please refer to Chapter 21.
12. Suman Sahai, "GATT and Patenting of Microorganisms", *Economic and Political Weekly*, April 9, 1994, p. 841.
13. Government of India, Planning Commission, *Tenth Five Year Plan* 2002-07 (New Delhi, 2003), Volume I, p. 127.
14. *Ibid.*, pp. 131-2.
15. Government of India, *Economic Survey* 2007-08 (Delhi, 2008), pp. 148-9.
16. In this context, please also see the section 'WTO and Indian Agriculture: Challenges and Priorities in the Global Economy' of Chapter 18.
17. *Tenth Five Year Plan*, *op. cit.*, pp. 122-3.
18. Non or minimally trade distorting subsidies are categorised as Green Box subsidies, less trade distorting subsidies are categorised as Blue Box subsidies, and trade distorting subsidies are categorised as Amber Box subsidies.
19. Biplab Dasgupta, *Globalisation: India's Adjustment Experience* (New Delhi, 2005), pp. 121-2. Dasgupta also quotes from a study of Hockman and Cremoux which states "If Japan, one of the richest countries in the world, with a per capita income that is 100 times more than that of India, and which can buy anything from anywhere in the world at any price, continues to provide more than 1000 per cent cover to its domestic rice production, on the ground that rice supply is too important to be left to the foreigners, then what ground could there be to abandon this target of food self-sufficiency in India now?", p. 124.
20. Government of India, *Agricultural Statistics at a Glance* 2006-07 (Delhi, 2007), Table 12.2.
21. UNDP, *Human Development Report* 2005 (Delhi 2005), p. 129.
22. Nayanima Basu, "WTO Signs TFA, Agrees on Peace Clause", *Business Standard*, November 28, 2014, p. 10.
23. D. Ravi Kanth, "India Eclipsed at WTO Ministerial", *Mint*, December 21, 2015, p. 5.
24. D. Ravi Kanth, "Multilevel Failure of WTO Ministerial at Buenos Aires", *Economic and Political Weekly*, December 30, 2017, p. 13.
25. *Ibid.*, p. 15.

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44 Chapter

PRICE TRENDS AND INFLATION

Price stability is an essential condition for stability in economic life as well as economic growth. ***Fluctuations in prices, on the contrary, create an atmosphere of uncertainty which is not conducive to development activity.*** Further, if prices rise steadily over a long period, a redistribution of national income and wealth takes place to the disadvantage of the poor, which eventually influences the demand pattern. In a market economy, producers carefully study the demand for their products and take decisions accordingly. Therefore, whatever be the changes in prices, they will ultimately influence the production. Investors also observe price movements. In order to estimate the profitability of a particular investment, they have to study the behaviour of prices in the market. In a state of uncertainty, an investor cannot estimate the profitability of investment which he would like to make. This will naturally discourage him and he may decide not to go ahead with his investment programme.

Since the beginning of the mid-1950s, prices have continuously risen in India. The rate of price rise, of course, has not been the same throughout the period. People generally do not bother about the price rise as long as it does not cause hardships to them. But once they discover that the rate of price rise is also increasing causing continuous erosion in their real income, they become panicky. This actually happened in India during the early 1970s. At this juncture, the government found that the plan was also in jeopardy and stabilisation of prices was imperative to save it. Hence, ***price stability is viewed as a necessary condition to ensure the desired development performance of the economy.***

In an attempt to explain price trends and inflation in India, we shall focus our attention on the following issues:

- Definition of wholesale price index and consumer price index
- Price movements during the planning period
- Factors on the demand side affecting prices
- Factors on the supply side affecting prices
- Consequences of the inflationary price rise
- Anti-inflationary policy of the government.
- Inflation targeting: Urjit Patel Committee Report

WHOLESALE PRICE INDEX AND CONSUMER PRICE INDEX

Wholesale Price Index. The Government of India revised the base year of Wholesale Price Index (WPI) from 2004-05 to 2011-12 from April 2017. WPI inflation measures the average change in the prices of commodities for bulk sale at the level of early stage of transactions. The basket of the WPI covers commodities falling under three major groups, namely primary articles, fuel and power, and manufactured products. The weights assigned for the three groups are as follows: primary articles 22.62 per cent, fuel and power 13.15 per cent, and manufactured products 64.23 per cent. The prices tracked are ex-factory prices for manufactured products, mandi prices for agricultural commodities, and ex-mines prices for minerals. Weight given to each commodity covered in the WPI basket is based on the value of production adjusted for net imports. WPI basket does not cover services. ***As compared to the earlier series (base year 2004-05 = 100), the new series with base year 2011-12 = 100 has more items (697 as compared with 676 in the earlier series) and is more representative in nature, drawing on 8,331 quotations as against 5,482 in the earlier series.*** Prices used for compilation do not include indirect taxes in order to remove the impact of fiscal policy. This is in consonance with best international practices and this makes the new WPI conceptually close to 'Producer Price Index'.[1] Item level aggregates for new WPI are compiled using geometric mean following international best practice and as is currently used for compilation of All India Consumer Price Index.[2]

Headline Inflation and Core Inflation. Headline inflation is a measure of the ***total inflation*** within an economy, including such as food and energy prices, which tend to be much more volatile and prone to inflationary spikes. On the other hand, core inflation does not take into account commodities that have volatile prices, for example, food and fuel. It follows that supply shocks that arise from a poor crop yield or hikes in international prices of fuel will lead to increase in headline inflation. However, core inflation will not be affected by these shocks. Thus, it serves as an indicator of the price levels of commodities that have

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(relatively) non-volatile prices. This shows that core inflation represents the long-run trend in the price level.

Consumer Price Index. Consumer Price Index (CPI) reflects the cost of living for a homogeneous group of consumers. The commodity basket for the CPI is derived from group-specific consumer expenditure surveys and weights for each commodity are proportionate to their expenditure. Since the focus is on cost of living in CPI, it is the retail prices that are taken into account. There are four consumer price indices in India: the CPI for industrial workers (CPI-IW), CPI for agricultural labour (CPI-AL), CPI for rural labour (CPI-RL) and CPI (urban + rural) combined. ***The new monthly CPI (combined), with base 2012 = 100, is now taken as the measure of headline inflation and is tracked by the RBI to anchor its monetary policy.***

As far as CPI (combined) is concerned, *Economic Survey* 2017-18 presents information on: (*i*) CPI headline inflation, (*ii*) CPI core inflation (i.e., CPI excluding food and fuel group) and (*iii*) CPI refined core inflation which is presented in two forms: (*a*) CPI excluding food and fuel group, petrol and diesel; and (*b*) CPI excluding food, fuel group, petrol, diesel and housing group.[3]

PRICE MOVEMENTS DURING THE PLANNING PERIOD

In this section, we try to present a study of the price movements during the planning period. However, the study is constrained by the fact that due to changes in the base period over a period of time, the results for the whole of the planning period are not strictly comparable.

Price Trends — The Earlier Period (1951 to 1981)

The whole planning period is now generally divided into two periods. The first period covering three decades from 1951 to 1981 was characterised by low growth (rate of growth in net national product at factor cost (2004-05 prices) being only 3.5 per cent. In the later period, that is, from 1981 onwards, the growth rate has been around 5.9 per cent per annum. In this section, we shall analyse price trends in the earlier period.

1. In the whole of the planning period starting from 1950-51 till now, it was only during the First Plan period that general price level recorded a fall. The Wholesale Price Index Number (Base year 1961-62 = 100) which stood at 89 in 1950-51 declined to 74 in 1955-56. In other words, the general price level in five years had fallen at an annual rate of 3.2 per cent.

2. The period starting from 1956-57 and continuing up to 1963-64 may be characterised as the period of moderate rise in the price level. Leaving aside a few extraordinary years, the price level in this period rose at an annual rate of about 5.1 per cent.

3. From 1964-65 onwards for about seventeen years, the general price level rose at an average rate of 9.5 per cent per annum. This price rise caused a lot of hardship to the people. However, the prices did not rise in this period at a uniform rate. For four years, that is, from 1964-65 to 1967-68 prices rose at an annual rate of 11.0 per cent per annum. Thereafter for the next three years, price rise was modest. In 1971-72, the price rise suddenly assumed alarming proportions, and from 1971-72 to 1974-75, the country passed through a phase of hyper-inflation. Though the average rate of inflation in this period was 16.3 per cent per annum, the rate of price rise in 1974-75 was alarmingly high at 25.2 per cent. Thereafter for three years, wholesale prices remained more or less stable. However, due to drought condition in 1979-80, the WPI which stood at 185.8 in March 1979 rose to 257.3 in March 1981 and further to 281.3 in March 1982. Hence, in the three year period, the rate of price rise was as high as 14.8 per cent per annum.

Price Trends — The Later Period (From 1981-82 onwards)

The wholesale prices in India during the period from 1981-82 to 1993-94 rose at an annual rate of 8.2 per cent. This certainly is not a low rate of inflation. During 1980s, there was never any respite from inflation. In 1990-91, the rate of inflation crossed double digit mark and stood at 10.2 per cent. In 1991-92 also, the rate of inflation remained stuck at a high level of 13.7 per cent. In 1992-93, prices increased at an average annual rate of 10.1 per cent. Overall, the average annual increase in prices during the first three post-reform years was 11.96 per cent. Price rise in the next two years was 10.7 per cent. The main reasons for this large increase in prices were heavy fiscal deficits and rise in administered prices. This double digit inflation was a great cause of concern.

During 1995-96, the inflation rate was brought down to 8.0 per cent and in 1996-97 to 4.6 per cent. However, it rose to 8.8 per cent in September 1998. The main reason for this was hefty rise in the prices of primary products especially vegetables, fruits, pulses and edible oils. The price level again started declining from November 1998 and by January 2000, the rate of inflation came down to 2.9 per cent. The main reason for this control of inflation was the slow growth in the money supply. Inflation picked up once again in 2000-01 to 7.2 per cent due to increase in the prices of petroleum products. However, inflation rate was

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relatively stable in 2001-02. Wholesale prices increased at the rate of only 3.6 per cent in this year. In 2002-03, due to drought conditions in as many as 14 States, there was a danger of a sharp increase in the prices of foodgrains followed by a rise in general price level. However, nothing of this sort happened. According to *Economic Survey* 2002-03, "Adequate release of surplus stocks of foodgrains helped in both keeping the inflation low and dampening the undercurrents of inflationary expectation."[4] The inflation rate in the initial two and a half months of the year 2004-05 was moderate but, on 52 week average basis, it was 6.5 per cent. ***During 2005-06, the average annual rate of inflation was 4.3 per cent.*** Under Indian conditions, if the inflation rate remains in the range of 4.5 to 5.0 per cent, it would be considered as a satisfactory position.

Towards the last quarter of 2007-08, inflationary pressures started building up again and the inflation rate rose to 8.02 per cent in March 2008. This was a matter of serious concern and a number of steps were announced to tackle the problem. In an effort to douse the inflation fire, the Reserve Bank of India raised the Cash Reserve Ratio (CRR) in phases from 7.50 per cent in April 2008 to 8.75 per cent on July 19, 2008. The Finance Minister also announced a number of measures in Parliament on April 29, 2008 to combat inflation. However, inflationary pressures continued to persist and ***the inflation rate touched 12.6 per cent on August 9, 2008.*** Reserve Bank hiked the CRR further to 9.0 per cent on August 30, 2008. During the last quarter of the financial year, 2008-09, the inflation rate started coming down mainly due to declining commodity prices and crude oil prices. This was basically due to economic slowdown which affected a number of manufactured goods and global recessionary trends which pulled down the prices of crude oil. The annual rate of inflation stood at 2.43 per cent for the week ended February 28, 2009 while it was 6.21 per cent in the corresponding week a year ago. ***For the week ended April 4, 2009, inflation rate dropped to just 0.18 per cent. Thus, the inflation rate based on WPI touched almost zero level.***

The year 2009-10 started with a low headline inflation of 1.3 per cent in April 2009, which moved into negative zone during June to August 2009 and increased faster in the second half to reach 11.0 per cent by March 2010. ***The overall average inflation during the year 2010-11 was as high as 9.6 per cent.*** A major concern was a sharp rise in food price inflation during the year 2010-11. This is one of the main reasons why inflation in terms of CPI remained at very high levels. High inflation in terms of CPI hit the consumers very hard. In a bid to check the rising prices, the RBI continued with its policy of increasing the repo and reverse repo rates. The repo rate was raised to 7.25 per cent and reverse repo rate to 6.25 per cent on May 3, 2011.

Financial year 2011-12 started with a headline inflation of 9.7 per cent, which briefly touched double digits in September 2011 before coming down to 6.6 per cent in January 2012. ***Headline WPI inflation remained relatively sticky at 8.9 per cent during 2011-12.*** Monetary policy stance during 2011-12 changed course during the year, from tightening driven by inflation concerns to gradual pause recognising the risks to growth. The monetary policy stance during May-October 2011 was based on the premise that over the long run, high inflation is inimical to sustained growth as it harms investment by creating uncertainty. Therefore, the Reserve Bank continued to increase repo rate and reverse repo rate. ***Over the period March 2010 to October 2011, the Reserve Bank raised repo rate by as many as 13 times (from 4.75 per cent on February 27, 2010 to 8.50 per cent as on October 25, 2011).*** But, because of a slowdown in the economy, the policy rates were kept unchanged thereafter (till the end of financial year 2011-12).

Trends in inflation based on the major series of price indices over the five year period 2012-13 to 2016-17 are presented in Table 44.1 (data for WPI are based on the new series (base year 2011-12 = 100) and data for CPI are based on the series with base year 2012).

Table 44.1

General Inflation Based on Different Price Indices

(per cent)

	2012-13	*2013-14*	*2014-15*	*2015-16*	*2016-17*	*2017-18*
WPI	6.9	5.2	1.2	–3.7	1.7	2.9
CPI (combined)	10.2	9.5	5.9	4.9	4.5	3.6
CPI (IW)	10.4	9.7	6.3	5.6	4.1	3.1
CPI (AL)	10.0	11.6	6.6	4.4	4.2	2.2
CPI (RL)	10.7	9.6	6.2	5.5	5.0	–3.0

Notes: 1. IW stands for Industrial Workers, AL for Agricultural Labourers, and RL for Rural Labourers.
2. CPI (combined) inflation for 2012-13 and 2013-14 is based on old series 2010 = 100.

Source: Government of India, *Economic Survey* 2017-18 (New Delhi, 2018), Volume II, Table 1, p. 56.

As is clear from this Table, inflation has been under control over the period of the last six years. In fact, the average inflation based on the new series (2011-12) of WPI was negative at –3.7 per cent in 2015-16 and was only 1.7 per cent in 2016-17 (it is probably on this account that some economists have argued that 'disinflationary trends'[5] have been witnessed in the Indian economy in the recent period). The average CPI-combined (CPI-C) inflation

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declined to 4.5 per cent in 2016-17 from 4.9 per cent in 2015-16 and further to 3.6 per cent in 2017-18. Similar declining trends are witnessed in the case of CPI (IW), CPI (AL) and CPI (RL).

Core Inflation. While significant moderation has been witnessed in the headline inflation, ***the CPI based core inflation has remained above 4 per cent during the last four financial years.*** However, it declined from 4.8 per cent in financial year 2016-17 (April-December) to 4.5 per cent in financial year 2017-18 (April-December) and was 5.2 per cent in December 2017. Refined core (CPI excluding food and fuel group, petrol and diesel) moved very close to core since the beginning of financial year 2017-18 – it declined to 4.4 per cent in financial year 2017-18 (April-December) from 5.0 per cent in financial year 2016-17 (April-December). Movements of refined core (excluding housing) track the refined core.[6]

Low inflation in 2016-17 was basically due to low food inflation commencing August 2016.[7] According to Reserve Bank, this was the confluence of several forces. "***First***, as the monsoon quickly gained full strength and spatial spread, conditions came together for a bumper ***kharif*** crop. ***Second***, anecdotal evidence pointed towards fire sales of perishables from November 2016 post demonetisation. ***Third***, the cumulative impact of the government's supply management measures, particularly with regard to pulses, sent the disinflationary spiral into overdrive." Average CPI (combined) inflation fell from 4.9 per cent in 2015-16 to 4.5 per cent in 2016-17 and further to 3.6 per cent in 2017-18. However, as correctly cautioned by Reserve Bank, the observed deceleration in headline inflation in India in the recent period (as shown in Table 44.1) could potentially be a transitory phenomenon in the wake of sharp correction in food prices and favourable terms of trade aided by decline in global commodity prices.[8] Therefore, there is no cause for complacency. If food prices increase and/or global crude oil prices rise (as is quite likely), inflationary pressures could firm up.

FACTORS ON THE DEMAND SIDE AFFECTING PRICES

An increase in aggregate demand is often a cause of rise in general price level. The price rise in India during the planning period also falls in this category. ***Increased public expenditure, in most cases supported by indiscriminate deficit financing at times when the supply of goods was not increasing, has caused inflationary price rise.***

1. Increase in public expenditure. The public expenditure in India has increased during the planning period and has thus generated considerable inflationary pressures. From 15.3 per cent of GDP in 1960-61, it rose to 17.2 per cent in 1970-71, to 25.6 per cent in 1980-81 and further to 29.3 per cent in 2016-17. At present approximately 40 per cent of the government expenditure in India is on non-developmental activities. No doubt, defence and maintenance of law and order are essential services for the stability of the society. At the same time, it must not be forgotten that due to their unproductive nature, expenditure on these activities results in inflationary price rise. The government expenditure on non-developmental services, by putting purchasing power into the hands of its employees, creates demand for goods and services, but it does nothing whereby their supply could increase. Under these circumstances, the general price level shows an inevitable tendency to rise. It is now generally agreed that ***the reckless increase in the government expenditure, particularly on account of large interest payments, defence expenditure and various types of unwarranted subsidies has led to large budget deficit which in turn has generated considerable inflationary pressures.***

2. Deficit financing. ***When a government is not able to raise adequate revenue for its expenditure, it can meet its deficit by borrowing funds from the banking system. This technique of resource mobilisation is called deficit financing.*** For the purpose of economic development, the government has not shown the necessary will to raise the required amount of capital through taxation though savings have steadily increased. Under these circumstances, there could be no escape from deficit financing. Under the Second and the Third Five Year Plans, the deficit financing had amounted to ₹ 954 crore and ₹ 1,133 crore respectively. Deficit financing of this size in a period of relatively slow growth turned out to be inflationary. Later on, even when the economy was overtaken by a deep crisis, the reliance on deficit financing was no less. In a period of eight years from 1966 to 1974, deficit financing amounted to ₹ 2,736 crore. The economy at this juncture had little capacity to bear this burden. But the government unmindful of the consequences, further indulged in indiscriminate deficit financing causing irreparable damage to the economy. During the Fifth Plan period, deficit financing amounted to ₹ 3,560 crore. Even in the recent years, when the economy has been under tremendous inflationary pressure, recourse to deficit financing has been a normal practice. The Sixth Plan had contemplated a deficit financing of ₹ 5,000 crore. However, the actual deficit financing during the Sixth Plan period was ₹ 15,684 crore. Reliance on deficit financing was no less under the Seventh Plan. As against the contemplated deficit financing of ₹ 14,000 crore in the Seventh Plan, the actual deficit financing was of the order

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of ₹ 34,669 crore. During the Eighth Plan period the budgetary deficit was as large as ₹ 61,134 crore which rose further to ₹ 1,06,983 crore in the Ninth Plan. However, the situation improved during the Tenth Plan period. While the first year of this Plan 2002-03 recorded a deficit of ₹ 3,042 crore, all other years recorded substantial surplus with the result that over this Plan (as a whole), there was an overall budgetary surplus of ₹ 1,10,208 crore. The first year of the Eleventh Plan (2007-08) also had a budgetary surplus of ₹ 12,430 crore. However, there was substantial deficit in all other years (excepting 2009-10). The overall deficit in the Eleventh Plan was ₹ 1,85,552 crore.

FACTORS ON THE SUPPLY SIDE AFFECTING PRICES

Factors on the supply side generally operate through their effect on the cost of production. But in a non-competitive market, producers often try to maximise their profits by creating artificial scarcities. In India, where production has not increased at the desired rate, hoarding of essential commodities and the government's price support policy have also contributed to the price rise. Main factors on the supply side affecting prices in India are as follows:

1. Erratic agricultural growth. The Indian agriculture has remained largely dependent on monsoon over the years and thus crop failures due to droughts have been a regular feature of agriculture in this country. In the years of scarcity of foodgrains, not only the prices of food articles increased, but the general price level also rose. Whenever the agricultural output declined in this country, market arrivals of agricultural products also declined. In many years, the decline in market arrivals was much more than the decline in the agricultural output and caused immense rise in agricultural prices. Since the weight allotted to agricultural products in the Index Number of Wholesale Prices is fairly high, a rise in agricultural prices automatically gets reflected in the rise in general price level. Moreover, under the pressure of rising prices of foodgrains, industrial workers who spend a major part of their incomes on food have forced their employers to raise their wage rates. Consequently, the prices of industrial goods have also risen in periods of falling agricultural production.

2. Hoarding of essential articles. Failure of crops always encouraged big farmers and the wholesale dealers in agricultural products to indulge in hoarding with the expectation that the prices of these commodities would rise. This behaviour of producers and middlemen is in clear conflict with the interests of the society. ***Hoarding, when production goes down in the country, aggravates scarcity conditions and pushes up the price level. Hoarding has been a common phenomenon in India throughout the period of economic planning.*** In recent times, hoarding of onions, oilseeds and pulses has caused steep rise in the prices of these commodities.

3. Agricultural price policy of the government. In order to provide incentives, particularly to farmers with marketable surplus, the government has been pursuing a policy of price support for about five decades. This entails announcing higher MSPs (minimum support prices) year after year to ensure that farmers get remunerative prices for their agricultural produce that not only cover their cost of production but also provide some profit margins. Some economists have argued that hiking MSPs year after year is one of the main causes of food inflation in this country. However, Ashok Gulati and Shweta Saini have recently argued that blaming the hike in MSPs for raising food prices is not just naive but is also indicative of the anti-farmer mindset that the country has conveniently nurtured over the years.[9]

4. Inadequate rise in industrial production. Industrial production increased at the rate of only 4.1 per cent per annum over the period 1965 to 1976 and at the rate of only 6.1 per cent per annum over the period 1974 to 1979. The year 1979-80, in fact, recorded a negative growth of −1.6 per cent. Because of this deceleration in industrial sector, there was a shortage of industrial goods and this created inflationary pressures in the economy. ***During the economic reform period (the period since 1991), there has been marked fluctuations in industrial production which has created conditions of instability and uncertainty.*** In such an atmosphere, inflationary pressures are bound to continue. During the period of the Ninth Five Year Plan, the rate of growth of industrial production was just 5.0 per cent per annum which rose considerably to 8.2 per cent per annum in the Tenth Plan but fell to 6.9 per cent per annum in the Eleventh Plan. Industrial growth rate was just 1.4 per cent per annum in the Twelfth Plan according to IIP (base 2004-05 = 100) and 3.7 per cent per annum according to IIP (base 2011-12 = 100). Rates of growth given here are simple average of annual growth rates.

5. Upward revision of administered prices. There are a number of important commodities for which price level has been administered by the government. Many of these administered prices are for commodities produced in the public sector. ***The government keeps on raising administered prices from time to time in order to cover up losses in the public sector which often arise due to inefficiency and unimaginative planning. Obviously the right policy would be to reduce costs by improving the efficiency in the public sector units.*** This, however, requires great efforts, and therefore, the government prefers the easier alternative,

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that is, raising administered prices. This policy results in what is known as the cost push inflation. During the last two decades, administered prices of petrol, petroleum products, coal, iron and steel, non-ferrous metals, electricity and fertilisers were raised at regular intervals. According to the government, these were necessary. They, however, triggered off inflationary process.

Besides the major factors which we have mentioned above, there were some other factors which caused a rise in the general price level in the country. Two factors which deserve particular mention are rising prices of imports and heavy taxation of the commodities of mass consumption. Till recently, inflation has been a worldwide phenomenon and prices have risen in both developed and underdeveloped countries. This had its repercussions on India's price structure. When the country paid more for imported machines, raw materials and other articles, the cost of production rose in the country pushing up prices. ***Over the years, the import prices of petroleum products have increased steeply, and their contribution to the domestic price rise is more than that of any other commodity.*** Secondly, the governments, both at Centre and the State levels, have relied heavily on indirect taxes for raising revenue. These taxes have invariably led to price rise.

CONSEQUENCES OF THE INFLATIONARY PRICE RISE

Economists often argue that a mild dose of inflation is good for an economy. When prices steadily rise at a rate of 4-5 per cent per annum, favourable climate is created for investment which eventually results in larger income and fuller employment. But the way prices have risen in India over the period of planning, has done more harm than good to the economy and the people. This not only inflicted sufferings on the multitude of people, but also disrupted the developmental efforts time and again. Let us now examine the consequences of inflation in more detail.

1. Increase in economic inequalities. When prices rise continuously over a long period, inequalities of income and wealth increase. People with fixed income such as workers, government employees, teachers, etc. find that inflation results in erosion of their purchasing power. Producers and traders, on the contrary, earn huge profits. This process if not immediately arrested wipes out even the lifetime savings of the people whose money incomes are more or less fixed, and the wealth of the country gets concentrated in the hands of traders and producers. In India, the price rise during the planning period has been a little less ruthless and savings of the working population have not been completely wiped out. But there is no doubt about the fact that the price rise has not always been accompanied by an upward revision of wage rates. Naturally the real wages of the various categories of workers have declined. ***The worst sufferers in the whole process have been the agricultural workers who are least organised in this country. With no alternative opportunities, their bargaining power is very little.*** Their money wage is generally determined conventionally and even a decline in the purchasing power of money will not alter it. Industrial workers and the government employees have powerful organisations to protect their interests. Naturally, they have succeeded to some extent in getting money wage-hikes in order to offset the erosion of their real wage. ***Big farmers, industrialists and traders have benefited the most from this inflationary price rise.*** Big farmers, who had large marketable surplus, earned huge profits, when prices of agricultural products rose. Traders and industrialists also made fortunes.

2. Obstacle to development. The continuous price rise during the planning period has turned out to be an obstacle to development. This is particularly due to the rigidity about plan outlays. When a plan is finalised and outlay determined, it is generally not revised even if it becomes necessary due to upward movement of prices. This approach invariably leads to non-completion of projects in the required period. Continuously rising prices in India in the past have discouraged savings. Unlike the West European countries where most of the savings are done in the private corporate sector, savings in India are mostly done in the household sector. Big corporations in the USA and other Western countries have saved more in the period of inflation with the expectation that they would make more profits by increasing their investments. In India, on the contrary, households for fear of erosion of real value of their savings have generally avoided them, and thus sources of finance have not grown keeping the rate of investment low.

According to C. Rangarajan, ***an important issue that arises in the context of development is "whether there is a trade-off between economic growth and inflation. In the short run perhaps there is such a trade-off. Some of the econometric models for India indicate the existence of a trade-off but at a heavy cost. A higher growth rate can be achieved only at the cost of a fairly high inflation rate. Over a long period, growth cannot be bought with the aid of higher prices. On the other hand, it is price stability which provides a better environment in which growth can occur and social justice can be ensured."***[10]

3. Changes in relative prices. Over the years, prices of all the commodities have not increased uniformly. In some years relative prices of agricultural products increased more rapidly than that of manufactured products while in other years it was the other way round — *i.e.*, the relative

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prices of manufactured products rose more rapidly than that of agricultural products. ***In those years when relative prices of agricultural products rose more rapidly, large farmers derived great benefits. For small farmers, this development had little relevance.*** Interestingly, in India, agricultural incomes have been exempted from the income tax. Therefore, not even a small fraction of the large income generated in the agricultural sector could be mobilised by the government for development projects in this sector. Farmers, particularly in Punjab, Haryana and Western UP, have invested this newly created income in the mechanisation of agriculture, which has led to displacement of some farm labour in these States. Thus, the prosperity of the rural rich due to inflationary price rise has inflicted sufferings upon the rural poor.

4. Adverse effects on the balance of payments. Although since the World War II, inflation has been a worldwide phenomenon, prices in India have risen more sharply than in most of the other countries. This created two problems in this country from the point of view of balance of payments. First, the demand for India's products declined in foreign markets and the task of increasing exports became more difficult. Moreover, in the home market the profitability increased and as such even the producers had little interest in stepping up exports. Secondly, Indian importers, finding that foreign goods were cheaper, tried to increase imports.

ANTI-INFLATIONARY POLICY OF THE GOVERNMENT

Measures adopted by the Government of India to control inflationary pressures can be discussed under the following headings:

Monetary Policy

In a growing economy like the one we have in this country, the central bank is not expected to be very rigid about the quantity of money. Normally, it should follow a policy of controlled expansion of money supply. Judging by this criterion, the policy of the Reserve Bank of India (RBI) does not seem to be quite satisfactory. Over the years, while meeting the demand for money made by the Central government for meeting its budgetary deficits, the RBI has actively contributed to creating inflationary pressures. Only when the price situation appeared to be somewhat out of control, it undertook various monetary control measures in a somewhat ad hoc manner for preventing further rise in prices.

For about three decades from 1962 to 1991, the RBI had employed both quantitative as well as qualitative measures of credit control. Until 1962 it had pursued the cheap money policy possibly on account of the firm belief at the decision making level that this policy could provide necessary inducement to invest in the private sector. When in the early 1960s inflationary pressures considerably increased, this policy was given up and the bank rate was raised a number of times and was finally fixed at 6 per cent in 1965. Upward revision in the bank rate once again became necessary in the early 1970s when general price level recorded an unprecedented increase. Within a period of three-and-a- half years beginning from January 1971, the bank rate was raised thrice. It was fixed at 9 per cent in July 1974. For a few years, the price situation did not cause much anxiety and as such the need for a further rise in the bank rate was not felt. However, when monetary expansion in 1979-80 generated fresh inflationary pressures the bank rate was raised to 10 per cent in July 1981. In India, on account of institutional deficiencies, open market operations were not undertaken to combat inflationary pressures.

During the 1980s, the RBI increasingly used the Cash Reserve Ratio (CRR) for limiting commercial banks' capacity to expand credit. In a country like India where on account of underdevelopment of the money market both bank rate policy and open market operations lack the desired effectiveness, there is no escape from relying heavily on changes in the CRR. To mop up excess liquidity in the banking system, the CRR was raised from 7 per cent to 9 per cent in four stages spread over a period from May 27, 1983 to February 4, 1984. CRR was raised further in later years and was fixed at 15 per cent with effect from July 1, 1989. Statutory Liquidity Ratio (SLR) was also raised to 35.5 per cent on July 28, 1984 and in stages, further to 38.5 per cent on September 22, 1990. The bank rate was revised upward to 11 per cent effective from July 4, 1991 and further to 12 per cent effective from October 8, 1991 to curb excessive liquidity. ***Bank rate presently stands at 6.0 per cent.***

On the recommendations of the Narasimham Committee, the government abandoned the policy of relying on CRR and SLR to control inflation. The RBI accordingly reduced both CRR and SLR in a phased manner. The effective SLR was brought down in stages to 25 per cent on October 25, 1997, 21.5 per cent on July 2, 2015 and further to 21.25 per cent on April 5, 2016. SLR is presently 18.75 per cent. The CRR which was reduced to 14 per cent effective from December 9, 1995, was brought down to 4.5 per cent from June 14, 2003. However, to check liquidity overhang in the system, the RBI raised the CRR to 5 per cent in two phases in October 2004. CRR has been used extensively as a measure to control inflation in this country. It was raised to 9.0 per cent on August 30, 2008.

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Thereafter, it was reduced. ***The final reduction was made on February 9, 2013 when the CRR was brought down to 4 per cent.***

In recent times, the Reserve Bank has relied basically on repo rate and reverse repo rate to control inflationary pressures. This would be clear from the fact that over the period March 2010 to October 2011, these rates were raised as many as 13 times. On October 25, 2011, repo rate was fixed at 8.50 per cent and reverse repo rate at 7.50 per cent. In its Monetary Policy for the year 2011-12 announced by the Reserve Bank on May 3, 2011, it was decided to shift towards a single policy rate regime — the repo rate. Thus, repo rate became the single independently varying rate. The reverse repo rate was pegged at 100 basis points (bps) below the repo rate (100 basis points is equal to 1 per cent). In March 2015, repo rate was fixed at 7.5 per cent and, accordingly, reverse repo rate became 6.5 per cent. In its Monetary Policy Statement issued on April 5, 2016, the Reserve Bank pegged the reverse repo rate at 50 basis points below the repo rate. Since repo rate was fixed at 6.5 per cent in this policy statement, reverse repo rate stood adjusted to 6.0 per cent. The repo rate was reduced to 6.25 per cent in October 2016 and the reverse repo rate to 5.75 per cent. In its Monetary Policy Statement issued on April 6, 2017, the Reserve Bank pegged the reverse repo rate at 25 basis points below the repo rate. ***Repo rate is presently 5.75 per cent. Consequently, reverse repo rate became 5.5 per cent.***

In respect of selective credit controls, the RBI has relied mainly on three techniques, *viz.*, determination of marginal requirements on advances against the security of essential commodities like foodgrains, sugar, oilseeds, cotton and vegetable oil; determination of ceilings on advances and other financial accommodation; and charging discriminatory interest rates on certain types of advances. The selective credit controls have now been abandoned as an anti-inflationary measure.

During the 1990s, there was a significant change in monetary environment. Since 1992-93 there was a steep rise in foreign exchange reserves with the RBI which impacted on the composition of reserve money. This obviously had potential consequences for domestic monetary expansion and inflationary price rise. The RBI thus chose to contain monetary expansion through sterilisation of the accumulated reserves via open market operations where it sold government securities.

The Reserve Bank introduced Liquidity Adjustment Facility (LAF) in June 2000. LAF operates through reverse repo auctions, *i.e.*, the sale of government securities from RBI portfolio for absorption of liquidity and repo auctions, *i.e.*, buying of government securities for injection of liquidity on a daily basis, thereby creating a corridor for the call money rates and other short-term interest rates, LAF has also emerged as the key instrument of managing capital inflows that India has experienced since 2001-02 through sterilisation. This has helped in reducing the episodes of volatility in foreign exchange markets. In April 2004, the Market Stabilisation Scheme (MSS) was introduced to provide the Reserve Bank with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilisation operations. The MSS is an arrangement between the Government of India and the Reserve Bank to mop up excess liquidity generated on account of the accretion to the foreign exchange assets of the Bank to neutralise the monetary impact of capital flows.[11]

Fiscal Policy

Fiscal policy can be effectively employed for checking inflation. In western countries due to built-in flexibility, manipulations in public expenditure, taxation and public debt obtain desired results. Their effectiveness in underdeveloped countries is, however, much less. Nonetheless, fiscal tools have been employed by the government in this country for curbing the inflationary price rise. First, the government has often claimed that it has always attempted to keep its non-developmental expenditure within reasonable limits. The developmental expenditure has, however, been allowed to increase rapidly as it assists in expanding the growth potential of the economy. Secondly, various tax incentives have been provided to producers in the private sector. These measures are expected to improve the supply position in course of time. Finally, efforts are being made to avoid deficit financing as far as possible. These claims made by the government are often disputed by the experts. In the face of steadily growing public expenditure and increasing reliance on deficit financing, it is difficult to believe that the government has effectively employed all the available fiscal tools for curbing inflation. However, the Budget for 1991-92 made an attempt to eliminate fiscal imbalance by bringing down fiscal deficit of the Central government from 7.8 per cent to 5.5 per cent of GDP. It seems that thereafter there was some laxity in pursuing this approach. Thus, in 1993-94 the fiscal deficit once again rose to a high level of 7.0 per cent of GDP and stood at 6.2 per cent of GDP in 2001-02 and 5.9 per cent of GDP in 2002-03. The Government adopted the Fiscal Responsibility and Budget Management (FRBM) Act in 2004 and committed itself to bring down the fiscal deficit. The Central government thus brought down its fiscal deficit to 4.0 per cent in 2005-06, 3.3 per cent in 2006-07 and further to 2.5 per cent in 2007-08. Because of economic slowdown in 2008-09 following global recession, the

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Government of India announced massive public expenditure programmes in this year to boost economic recovery. As a result, fiscal deficit of the Central government rose to as high as 6.0 per cent of GDP in 2008-09. The fiscal deficit rose further to 6.5 per cent of GDP in 2009-10. ***After declining to 4.8 per cent of GDP in 2010-11, fiscal deficit of the Central government again rose to 5.8 per cent of GDP in 2011-12 but fell to 4.9 per cent in 2012-13 and further to 3.3 per cent of GDP in 2018-19.***

Public Distribution System

Over the years, supplies of essential consumer goods have often fallen short of their demand forcing rapid increase in general price level. To deal with this situation, an efficient management of the supplies of essential consumer goods is of crucial importance. The government admitted long ago that, in the given situation, public distribution alone would ensure supplies of essential consumer goods of mass consumption to people at reasonable prices. This system has also been found necessary for operating the dual pricing arrangement in case of certain essential commodities.

On the basis of the past experience in this country ***an efficient public distribution system requires a nexus between production, procurement, storage, transportation and distribution of essential consumer goods. In India, until recently, these activities lacked proper coordination.*** However, there is no denying the fact that the country now has an elaborate infrastructure for public distribution. At the national as well as the State level, arrangements exist for procuring essential commodities and supplying them through the public distribution outlets.

Supply Side Measures

In order to improve supply position of essential commodities the government has often allowed their imports. From this point of view, imports of edible oils (except coconut oil), palmolein, sugar and pulses have been allowed in different years. Further, the Food Corporation of India has continued its open market sale of rice and wheat to prevent increases in their market prices. Finally, with the abolition of quantitative controls, import of essential commodities can be made easily to augment their supply. This will naturally keep inflation under control.

These measures have succeeded temporarily in the past in moderating rapid increase in the general price level, but they will not be effective enough to stabilise prices in the long period. The government itself has admitted, ***"Sustained increase in production in response to rising demand holds the key to price stability."***[12] This solution, however, is not easy to implement. From the macroeconomic point of view, the maintenance of a reasonable stability in prices is a rather difficult task under the existing conditions.

INFLATION TARGETING: URJIT PATEL COMMITTEE REPORT

An 'Expert Committee to Revise and Strengthen the Monetary Policy Framework' was appointed in September 2013 by the then Governor of the Reserve Bank of India, Raghuram Rajan, under the chairmanship of Urjit R. Patel (now Governor of the Reserve Bank of India) to "examine the current monetary policy framework of the Reserve Bank and recommend what needs to be done to revise and strengthen it with a view to, *inter alia* making it transparent and predictable." In addition to other tasks, the Committee was also assigned the task "to recommend an appropriate nominal anchor for the conduct of monetary policy." The Committee submitted its Report in January 2014.

Need for Inflation Targeting

The Report pointed out that in recent years, inflation in India has been amongst the highest within the G-20 nations (with WPI averaging 7.5 per cent and CPI-IW averaging 10.1 per cent over the period 2008-12).[13] According to the Committee, this has had the following consequences: ***First,*** with high and persistent inflation, real interest rates have remained negative for savers during most of the post-global crisis period leading to a decline in domestic financial saving. ***Second,*** since India's inflation has persisted at a level higher than that of trading partners, external competitiveness is getting eroded. ***Third,*** as the recent experience demonstrated, the large demand for gold as a hedge against inflation exacerbated the decline in financial savings and contributed to a widening of the current account deficit (CAD), rendering the economy vulnerable to external shocks. ***Fourth,*** the consequent weakening of the exchange rate has imposed balance sheet risks on borrowers in foreign currency with the potential for financial instability. ***Fifth,*** persistently high inflation adversely impacts the economy's allocative efficiency and impedes growth. ***Sixth,*** high and persistent inflation contributes to a worsening of income distribution as the poor use disproportionately higher cash-in-hand as part of their savings.

On account of the above reasons, the Committee argued that 'at the current juncture, bringing down inflation must be accorded primacy'. Accordingly, it has advocated the adoption of a policy of ***inflation targeting.*** Such targeting "tasks monetary policy to achieve price stability as an unambiguous and sustainable goal which the private sector can anchor its expectations about future inflation."[14] Moreover, it is simple, easily communicated and hence, well understood by the public at large. By promoting low and stable inflation expectations, it contributes to producing a desirable macroeconomic outcome.

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The Choice of Inflation Metric: WPI Versus CPI

Until recently, the RBI communicated indicative inflation projections in terms of the WPI alone, essentially because it is the only measure of prices at a national level and CPIs have traditionally addressed prices facing specific sections of society (CPI-IW for industrial workers, CPI-AL for agricultural labour and CPI-RL for rural labour). However, introduction of CPI-Combined in 2011 has now enabled the RBI to provide indicative projections of inflation in terms of CPI. As correctly pointed out by the Committee, ***the true inflation that consumers face is in the retail market.*** Therefore, CPI captures the inflation faced by households better than WPI and is a better indicator of the cost of living. Moreover, it is familiar to large segments of the population and is often used in both public and private sectors as a reference in the provision of government benefits or in wage contracts and negotiations. Importantly in India, unlike the WPI, the CPI is not subject to large revisions, which enhances its utility to the public and its usefulness for monetary policy purposes. Moreover, the CPI-Combined has a comprehensive coverage across regions as well as commodity groups including services (WPI does not include services).

On account of the above reasons, the Urjit Patel Committee chose CPI as inflation metric in India rather than WPI. Accordingly, the Committee recommended that ***"the RBI should adopt the new CPI (combined) as the measure of the nominal anchor for policy communication. The nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other relative metrics."***[15]

Fixing of Numerical Target

Urjit Patel Committee recommended the nominal anchor or inflation target at 4 per cent with a band of +/–2 per cent around it (*i*) in view of the vulnerability of the Indian economy to supply/external shocks and the relatively large weight of food in the CPI; and (*ii*) the need to avoid a deflation bias in the conduct of monetary policy. However, according to the Committee, "in view of the elevated level of current CPI inflation and hardened inflation expectations, supply constraints and weak output performance, the transition paths to the target zone should be graduated to bringing down inflation from the current level of 10 per cent to 8 per cent over a period not exceeding the next 12 months and 6 per cent over a period not exceeding the next 24 month period before formally adopting the recommended target of 4 per cent inflation with a band of +/–2 per cent."[16] ***In accordance with the recommendations of the Committee, the Reserve Bank of India and the Government of India signed an agreement on February 20, 2015. The agreement put in place a monetary policy framework which makes flexible inflation targeting the official goal of the central bank.***

In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework. The amended RBI Act also provides for the inflation target to be set by the Government of India, in consultation with the Reserve Bank, once in every five years. Accordingly, ***the Central Government has notified in the Official Gazette 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.*** The Central Government has notified the following as factors that constitute failure to achieve the inflation target: (*i*) the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or (*ii*) the average inflation is less than the lower tolerance level for any three consecutive quarters.

Should Inflation Targeting be the Sole Concern of RBI?

In a developing country, the central bank is expected to focus on a multiplicity of objectives including price stability, growth, employment, equity and social justice and also promote and nurture new monetary and financial institutions. This is what Reserve Bank has been doing all along (in this context, see Chapter 47 on 'The Reserve Bank of India'). As against this, the Patel Committee recommended focusing only on one objective: inflation targeting.

Globally, until 2008, some countries, a few at the push of IMF had been switching over to an inflation targeting regime after the successful adoption by New Zealand (1989), Canada (1990) and the UK (1992). A few emerging market economies also followed like Israel (1997) and South Korea (1998). However, the great recession in 2008 stemmed the tide and the conversion to inflation targeting by both advanced and emerging markets stopped immediately. ***There is a consensus growing internationally that monetary policy should move away from its narrow focus on inflation towards a multiple target-multiple instrument approach without swerving from a commitment to price stability over the medium term.*** In the light of this experience, critics have rightly questioned the sole concern with inflation targeting and neglecting other objectives of monetary policy.

In addition to questioning the very rationale of focusing on a single objective of inflation targeting, critics point out that such targeting does not help control inflation. Those who argue for inflation targeting assert that today's inflation

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is determined by the expectation of inflation tomorrow. Asserting further that the central bank controls inflation, they propose that the central bank merely needs to announce a lower inflation target and a rational public will scale down expectation of inflation and thus lower the inflation level. However, this is too simplistic a view. As pointed out by Pulapre Balakrishnan, even an institution as formidable as the Bank of England has had to write repeatedly to the government explaining why it slipped on the inflation targets agreed upon. The problems are still more difficult in India. This is due to the reason that the agricultural sector continues to play an important role in generating and sustaining inflation in India. This sector, in turn, is plagued by serious problems of supply-demand imbalance as natural factors play an important role in determining the level of output. At the same time, the government continues to hike minimum support prices and procurement prices even as public stocks have piled up. As correctly pointed out by Pulapre Balakrishnan, in the face of both types of food inflation — supply-demand imbalances and higher producer prices — a central bank has no instruments. The RBI's justification that "it anchors inflationary expectations" by raising the interest rate is no more than whistling in the dark.[17] Unless the supply response of the agricultural sector (and also manufacturing sector) improves and the problems of volatility and fluctuations in supply tackled satisfactorily, inflationary pressures will not ease. And in this respect, a single-focus policy of inflation targeting can be of no help.

NOTES

1. For definition of producer price index, please see 'Definition of Terms Used in the Book'.
2. Government of India, *Economic Survey* 2016-17 (New Delhi, 2017), Volume II, Box 3, pp. 115-6.
3. Government of India, *Economic Survey* 2017-18 (New Delhi, 2018), Volume II, pp. 57-8.
4. Government of India, *Economic Survey* 2002-03 (New Delhi, 2003), p. 79.
5. For meaning of disinflation, please see 'Definition of Terms Used in the Book'.
6. *Economic Survey* 2017-18, *op. cit.*, p. 58.
7. Food inflation declined to 4.2 per cent in 2016-17 from 4.9 per cent in 2015-16 and 6.4 per cent in 2014-15. It fell to just 1.2 per cent during April-December of the financial year 2017-18. In this context, see *Economic Survey* 2017-18, *Ibid.*, p. 57.
8. Reserve Bank of India, *Annual Report* 2016-17 (Mumbai, 2017), Box II.4, pp. 24-5.
9. In their own quantitative exercise (for the period covering 1995-96 to 2012-13) to determine the factors that gave rise to food inflation, Ashok Gulati and Shweta Saini zeroed in on three factors: exuberantly high fiscal deficits (Centre and States), high and growing agri-labour wage rates, and rising global prices. See Ashok Gulati and Shweta Saini, "25 Years of Policy Tinkering in Agriculture", in Rakesh Mohan (ed.), *India Transformed: 25 Years of Economic Reforms* (New Delhi, 2017), p. 281.
10. C. Rangarajan, "Issues in Monetary Policy", in P.R. Brahmananda and V.R. Panchamukhi (eds.), *The Development Process of the Indian Economy* (Bombay, 1987), p. 842.
11. For a detailed discussion on LAF and MSS, please refer to the section 'Short-term Liquidity Management' in Chapter 47 on 'Reserve Bank of India'.
12. Government of India, *Economic Survey* 1984-85 (New Delhi, 1985), p. 46.
13. Reserve Bank of India, *Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework* (Mumbai, January 2014), Table II.1, p. 4.
14. *Ibid.*, p. 6.
15. *Ibid.*, p. 18.
16. *Ibid.*, p. 19.
17. Pulapre Balakrishnan, "The Case against Inflation Targeting", *Business Line*, March 30, 2014.

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45 Chapter

INDIAN MONEY MARKET

Money market refers to a mechanism whereby on the one hand borrowers manage to obtain short-term loanable funds and on the other, lenders succeed in getting creditworthy borrowers for their money. In any money market, commercial banks are the most important lenders. These banks are, however, not merely the lenders of money, they also create credit. The central bank's role is important as the controller of credit.

According to Y. Venugopal Reddy, "The money market is expected to perform three broad functions:

First, it should provide an equilibrating mechanism to even out demand for and supply of short-term funds.

Second, it should provide a focal point for central bank intervention for influencing liquidity and the general level of interest rates in the economy.

Third, it should provide reasonable access to providers and users of short-term funds to fulfil their borrowing and investment requirements at an efficient and market clearing price."[1]

In this chapter, we shall discuss:

- The Indian money market and its unorganised and organised sectors
- Characteristics of the Indian money market
- Reform measures to strengthen the Indian money market and outlook for future.

THE INDIAN MONEY MARKET

The Indian money market is not an integrated unit. It is broadly divided into two parts, viz., the unorganised and the organised. There is compartmentalisation between the two markets and as such the rates of interest differ in the unorganised sector from those in the organised sector. The unorganised sector of the money market comprises unregulated non-bank financial intermediaries, the indigenous bankers and the moneylenders. This, in fact, is not a homogenous sector. Moneylenders, indigenous bankers and unregulated non-bank financial intermediaries who constitute this sector differ in many respects. Their organisations as well as the operations are not the same everywhere. Moreover, unlike modern banks there are little business relations between them. The organised sector on the other hand is fairly integrated. Both nationalised and the private sector commercial banks constitute the core of the organised sector. The foreign banks, co-operative banks and the Reserve Bank of India (RBI), the Discount and Finance House of India (DFHI), development finance institutions like IIBI and IFCI and investment finance companies like the LIC, GIC and UTI and mutual funds are the other institutions which operate in the organised sector of the Indian money market. ***The RBI is the apex organisation in the Indian money market.*** Since it is the leader and controller of the money market, it has great responsibility in respect of smooth functioning of the financial system. In April 1988, the RBI set up the Discount and Finance House of India (DFHI) to perform the function of stabilising the money market.

UNORGANISED SECTOR OF THE INDIAN MONEY MARKET

Unregulated non-bank financial intermediaries such as finance companies, chit funds, nidhis, etc., indigenous bankers, and moneylenders operate in the unorganised sector of the Indian money market. Lendings of the moneylenders are rather small, but some finance companies, chit funds and indigenous bankers do a considerable amount of business. They pursue banking business on traditional lines.

Unregulated Non-Bank Financial Intermediaries

In India, there are several types of unregulated non-bank financial intermediaries. Among these the most prominent are loan or finance companies, chit funds and *nidhis*. ***Loan companies*** (also called finance companies) are found in all parts of the country. The exact number of loan companies is not known. In addition, a large number of partnership firms and individuals are engaged in lending business. Loan or finance companies often succeed in raising substantial funds in the form of deposits, borrowings and other receipts. Usually from around one-fifth to one-fourth of their resources represent their net owned funds. Finance companies generally give loans to retailers, wholesale traders, artisans and other self-employed persons. Since

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finance companies charge high rates of interest varying from 36 to 48 per cent, normally those who borrow from these companies are persons who are unable to get credit from commercial banks.

The ***chit funds*** are savings institutions. They are of various types lacking any standardised form. A chit fund has regular members who make periodical subscriptions to the fund. The periodic collection is given to some member of the chit fund selected on the basis of previously agreed criterion. Normally, the selection of the beneficiary is made either on the basis of bids or by draw of lots. In any case, each member of the chit fund is assured of his turn before the second round starts and any member becomes entitled to get periodic collection again. The chit fund business is now done in almost all the States but Kerala and Tamil Nadu account for the major part of total chit fund business. Estimates of deposits received by the chit fund companies and their annual turnover are not available. The RBI has absolutely no control over the lending activities of the chit funds.

The ***nidhis*** operate particularly in South India. They are in their character as some kind of mutual benefit funds because their dealings are restricted only to the members. Since the *nidhis* operate in the unregulated credit market, there is hardly any information available about the amount of lending business done by them. However, the deposits mobilised by them are not much. The principal source of their funds is deposits from the members. The loans are given to members at relatively reasonable rates for purposes such as house construction or repairs, etc., and are secured. The *nidhis* are highly localised single office institutions. Mainly middle class families in urban centres have shown interest in this institution.

Indigenous Bankers

Indigenous bankers are individuals or private firms which receive deposits and give loans and thereby operate as banks. Since their activities are not regulated, they belong to the unorganised segment of the money market. The indigenous bankers should be distinguished from the moneylenders because the latter's main business is money lending rather than financial intermediation. The indigenous bankers have been engaged in the banking business in both ancient and medieval periods. They received set-back with the introduction of modern banking after the arrival of the British. Over the past five decades with the growth of commercial and co-operative banking, the area of the operations of the indigenous bankers has contracted further. Still there are a few thousand indigenous bankers particularly in the western and southern parts of the country who are engaged in traditional banking business. The volume of their credit operations is however not known.

Indigenous bankers do not constitute a homogeneous group. Broadly, they may be classified under four main sub-groups — Gujarati Shroffs, Multani or Shikarpuri Shroffs, Chettiars and Marwari Kayas. The Gujarati Shroffs operate in Mumbai, Kolkata and the industrial and trading cities of Gujarat. The Marwari Shroffs are active in Kolkata, Mumbai, tea-gardens of Assam and other parts of North-East India. The Multani or Shikarpuri Shroffs are to be found mainly in Mumbai and Chennai and the Chettiars are concentrated in the South. Of the four main such groups of the indigenous bankers, the Gujarati indigenous bankers are the most important in terms of the volume of business.

Over the past few decades, the indigenous bankers have faced stiff competition from the commercial and co-operative banks. Nevertheless, they have survived due to various factors favourable to them. ***Firstly,*** in the urban areas, especially in the metropolitan cities of Mumbai, Kolkata and Chennai credit from the indigenous bankers is sought by small manufacturers and small traders because commercial banks often do not meet the credit needs of this section of borrowers adequately. ***Secondly,*** while the commercial banks do not provide unsecured loans, a part of the credit provided by the indigenous bankers is in the form of clear advances which is of great value to small borrowers. ***Thirdly,*** the indigenous bankers offer personalised, informal and prompt services to the borrowers which they appreciate. In contrast, the approach of the commercial banks is entirely formal. ***Fourthly,*** the operation and establishment costs of the indigenous bankers are lower and they are not required to maintain cash reserves with the RBI or invest heavily in low-return government securities. ***Finally,*** the indigenous bankers know their borrowers well because they are local parties. Consequently, the risk of default is generally low.

The indigenous bankers are engaged in non-banking business also and are totally unwilling to separate their banking and non-banking activities. It is, in fact, this approach of the indigenous bankers which has prevented their integration into the organised money market. Even in the unorganised money market, the indigenous bankers remain highly segmented and thus funds do not move easily in it. Further, the lending operations of the indigenous bankers are completely unsupervised and unregulated. They often do not care about the end-use of credit. This naturally weakens the credit control of the RBI. The bank rate policy of the RBI has no bearing on the lending rates of the indigenous bankers who charge excessively high rates of interest.

Moneylenders

Moneylenders do not constitute one homogeneous category. Broadly they are of two types: (1) Professional

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moneylenders whose main activity is money lending; and (2) Non-professional moneylenders whose main source of income is not money lending. The methods of operation of the moneylenders are not uniform. Their activities are generally localised. The main features of moneylenders as a source of credit are as follows:

1. Moneylenders generally do not receive deposits. Their funds are mostly their own. They rarely borrow from banks or other financial institutions to conduct their lending business.

2. The borrowers from the moneylenders are generally poor such as, agricultural labourers, marginal and small farmers, artisans, factory and mine workers, menials and other low paid workers and small traders. These relatively poor persons fail to get credit from any other source and therefore, their bargaining position *vis-à-vis* the moneylenders is very weak.

3. Moneylenders charge usurious rates of interest. They also indulge in various malpractices such as, frequent compounding of interest, false manipulations of loan records and extracting *begar* (free labour) from the defenceless borrowers. Moneylenders often use strong arm methods to force the debtors into their bondage.

4. The moneylenders' credit is both unsupervised and unregulated which exposes the borrowers to worst kinds of exploitation. Moneylenders grant loans for productive purposes as well as for consumption. Generally, the borrowers find it difficult to repay consumption loans because the rate of interest on these loans is exceptionally high. In the process, the borrower loses the security to the moneylender. In the countryside, moneylenders often deprive marginal and small farmers of their land, cattle, crops and ornaments by advancing paltry amounts.

In the absence of institutional sources of credit for the poorer sections of the society, the moneylenders' credit has become a necessary evil. In the past, several legislative measures have been passed to prevent exploitation of the borrowers by the moneylenders but most of the legal provisions have remained unenforced due to various administrative difficulties and also because of lack of political will to enforce them. It is generally agreed that the small borrowers can be protected from the exploitation of the moneylenders only by developing the institutional sources of credit.

ORGANISED SECTOR OF THE INDIAN MONEY MARKET

The modern sector of the Indian money market is reasonably well organised and integrated. Leaving aside some highly developed financial centres, the organised sector of the Indian money market is far more organised and developed than the money markets in most of the countries. ***The organised sector of the Indian money market comprises the RBI, commercial banks, foreign banks, co-operative banks, finance corporations, mutual funds and the Discount and Finance House of India Limited (DFHI).***

Mumbai, Kolkata, Delhi, Chennai, Ahmedabad and Bangalore are the principal centres of the organised sector of the Indian money market, of which Mumbai is the most prominent. The Mumbai money market has now become synonymous with the Indian money market. At present the Mumbai money market occupies the same position in India as the London money market in England and the New York money market in the USA. The presence of the head offices of the RBI and various commercial banks, the leading stock exchange, well organised market of the government securities, the bullion exchange and the cotton exchange have made Mumbai the most prominent financial centre of the country.

No doubt the organised sector of the Indian money market is fairly developed and organised, yet it is not comparable to the New York or the London money market. ***Broadly the principal constituents of the organised sector of the Indian money market are: (i) The Call Money Market, (ii) The Treasury Bill Market, (iii) The Repo***

Box 45.1

Organised Sector of the Indian Money Market

Sub-Markets
- Call Money Market
- Treasury Bill Market
- The Repo Market
- Commercial and Trade Bills Market
- Certificate of Deposits Market
- Commercial Paper Market
- Money Market Mutual Funds

Participating Institutions
- Reserve Bank of India
- Discount and Finance House of India
- Banks
- Development Financial Institutions
- Investment Finance Companies
- Mutual Funds

Instruments
- Treasury Bills
- Repos
- Inter Bank Call Money
- Commercial and Trade Bills
- Commercial Paper
- Certificates of Deposits
- Participation Certificates

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Market, (iv) The Commercial Bill Market, (v) The Certificates of Deposits Market, (vi) The Commercial Paper Market and (vii) Money Market Mutual Funds. Box 45.1 shows the structure of the organised sector of the Indian money market.

The Call Money Market

The call money market exists in almost all developed money markets. It is generally the most sensitive part of the financial system. Any change in flow of funds and the demand for them is clearly reflected in it. The response is generally quick. In India, the call money market is centred at Mumbai, Kolkata and Chennai. Among these, the market at Mumbai is the most important. ***The call money market is an important segment of the money market where uncollateralised borrowing and lending of funds takes place on overnight basis.*** Participants in the call money market currently include scheduled commercial banks (excluding regional rural banks), co-operative banks (other than land development banks), and primary dealers, both as borrowers and lenders (RBI's Master Circular dated July 1, 2011). Prudential limits in respect of both outstanding borrowing and lending transactions in the call money market for each of these entities are specified by the Reserve Bank of India.

Brokers play an important role in the call money market as they keep in touch with banks in the city and continuously try to bring borrowing and lending banks together. In the banking system there are no permanently surplus or deficit banks. In fact, their cash position keeps on changing from hour to hour. Therefore, there has to be a system whereby temporary cash surpluses of some banks should be available to others who have temporary deficit. ***The call money market provides an institutional arrangement which serves this purpose.*** When one bank faces a temporary shortage of cash, it borrows from another bank that has surplus cash. Money that is thus lent for one day, or on overnight basis, is known as call money. The call money market on account of its highly sensitive nature is considered to be the most appropriate indicator of the liquidity position of the money market. The RBI, therefore, takes note of it in adjusting its day-to-day monetary policy.

During the 1980s the call money rate was an administered one. The ceiling at 10 per cent was fixed by the Indian Banks Association. This was the time when there were a few large lenders and a large number of borrowers in the call money market. Since in this period there were not many participants who alternated as both lenders and borrowers, the call money market failed to develop adequately. The UTI and the LIC were large lenders. They were not allowed to operate as borrowers. These investment institutions had a sizeable short-term float which they could profitably deploy in the call money market. The commercial banks were usually the borrowers. Their needs for short-term funds often coincided. Among the banks, only the State Bank of India was sometimes on the lender's side on account of its strong liquidity position.

On the recommendation of the Vaghul Committee, the DFHI was set up in April 1988. In July 1988, the DFHI was allowed to operate both as lender and borrower in the call money market. The operations of the DFHI were exempted from the ceiling rate set by the Indian Banks Association. These measures helped in the development of the call money market as they corrected imbalances in the supply and demand for funds in the market. With the participation of DFHI in the call money market, there was a significant increase in its annual turnover.

In May 1989, the ceiling on call money rate was withdrawn. In May 1990, the RBI allowed the IDBI, the GIC and the NABARD to participate in the call money market as lenders. In October 1993, the participating development banks and the financial institutions were allowed to borrow up to an aggregate limit of ₹ 1,000 crore with individuals limits to be fixed for borrowing from time to time.

Since the withdrawal of ceiling on the call money rate there have been sharp fluctuations in it due to imbalances in the demand and supply of bank reserves. The imbalances in the demand and supply of bank reserves arose on account of several factors. The most important of these has been a bunching up of the banks' needs for short-term funds in order to meet cash reserve ratio (CRR) requirements. Another contributing factor has been the unsound policy of some of the large banks to invest in medium and long-term assets by borrowing from the call money market. Finally, the occasional withdrawal of liquidity from the banking system by the government led to imbalances in the demand and supply of bank reserves.

According to Kunal Sen and Rajendra R. Vaidya, instability in the call money rates in the post-1990 period notwithstanding, "with the deregulation of the interest rate and the widening of the market through the participation of more non-bank financial institutions as both lenders and borrowers, the call money market has been playing an increasingly important role in equilibrating the banking system's demand and supply of short-term funds. Clearly, with the growth in the size of the call money market (as evident by the increase in DFHI's annual turnover), the need for commercial banks to hold on to excess reserves to meet any unanticipated deposit withdrawals by bank customers has been greatly reduced, thereby lowering bank

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intermediation costs. The setting up of DFHI in 1988 and its emergence as 'a major force in the call money market' have also contributed to the development of the market."[2]

The turnover and interest rates in the call money market generally reflect varying liquidity conditions. The average call rate (which is the average of daily weighted call money borrowing rates) was 5.9 per cent in 2017-18 and 5.9 per cent in 2017-18. Average daily turnover in the call money market during 2017-18 was ₹ 281.1 billion.

The Treasury Bill Market

The market which deals in treasury bills is known as the treasury bill market. In India, treasury bills are short-term liability of the Central government. Theoretically treasury bills should be issued for meeting temporary deficits which a government faces due to its excess of expenditure over revenue at some point of time. However, in India till recently they were a permanent source of funds for the Central government, as every year more new bills were issued than those retired. Further, every year a part of treasury bills held by the RBI was converted into long-term bonds.

The treasury bill market in India is very much undeveloped. Except the RBI, there are no major holders of treasury bills. In fact, even the RBI is a passive or captive holder of these bills which implies that it is under an obligation to purchase all the treasury bills which are being offered to it by the government. It is also required to rediscount whatever treasury bills are presented to it by banks and others for this purpose. This has resulted in the monetisation of public debt and has been a major source of inflationary expansion of money supply. At present, the RBI holds most of the outstanding treasury bills. Other holders, such as commercial banks, State governments and semi-government bodies do not hold them in large quantities. Non-bank financial intermediaries, and corporate and non-corporate firms do not hold treasury bills. ***In contrast, in the USA and the UK, treasury bills are the most important money market instrument, and as a result the open market operations of the central bank in these countries are quite effective.*** Since April 1, 1997, however, wide-ranging changes have been made in respect of the treasury bills so as to make this segment more vibrant and responsive to policy changes. Effective from April 1, 1997, ad hoc and on-tap treasury bills were replaced by Ways and Means Advances for financing the Central government's temporary deficits. This was expected to prevent monetisation of public debt and inflationary expansion of money supply.

The following types of treasury bills are in use in India:

91-Day Treasury Bills. Earlier, there were two types of 91-day treasury bills — ordinary and *ad hoc*. With effect from April 1, 1997 *ad hoc* treasury bills were discontinued. In 1992-93, a scheme for the issue of 91-day treasury bills with the RBI participation was introduced.

182-Day Treasury Bills. 182-day treasury bills were introduced with effect from May 26, 1999. Auction of these treasury bills was discontinued from May 14, 2001 and reintroduced from April 6, 2005.

364-Day Treasury Bills. 364-day treasury bills were introduced in April 1992. Since then these treasury bills are auctioned on a fortnightly basis in a regular manner. These treasury bills are not rediscountable with the RBI. However, they offer short-term investment opportunities to banks and other financial institutions. Since 364-day treasury bills constitute a safe avenue for investment, the auctions of these treasury bills have evoked good response. 10-year G-security yield in 2017-18 was 7.0 per cent while 91-day treasury bill yield was 6.2 per cent. Average daily G-security market turnover in 2017-18 was ₹ 537.7 million.

The Repo Market

Repo is a money market instrument which helps in collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. ***Repo rate is the rate at which Reserve Bank lends to the banks while reverse repo is the rate at which it borrows from the banks.*** In other words, repo rate is the price at which the Reserve Bank injects liquidity into the system while the reverse repo rate is the price at which it absorbs liquidity from the system. An increase in these rates signals a rise in interest rates. This policy is resorted to under inflationary conditions when the focus is on squeezing the liquidity. It was precisely with this end in view that the Reserve Bank has been raising these rates in recent period. In fact, repo rate has emerged as the single policy rate in recent times to manage short-term liquidity in the system. In its Monetary Policy Statement issued on April 6, 2017, the Reserve Bank pegged the reverse repo rate at 0.25 per cent below the repo rate. ***The repo rate is presently 5.75 per cent. Consequently, reverse repo rate became 5.50 per cent.***

Initially, repos were allowed in the Central government treasury bills and dated securities created by converting some of the treasury bills. In order to make the repo market an equilibrating force between the money market and the government securities market, the RBI gradually allowed repo transactions in all government securities and treasury bills of all maturities. Lately State government securities, public sector undertakings' bonds and private corporate securities have been made eligible for repos to broaden the repo market.

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The Commercial Bill Market

The commercial bill market is the sub-market in which the trade bills or the commercial bills are handled. The commercial bill is a bill drawn by one merchant firm on the other. Generally, commercial bills arise out of domestic transactions. The legitimate purpose of a commercial bill is to reimburse the seller while the buyer delays payment. In India, the commercial bill market is highly undeveloped. The two major factors which have arrested the growth of a bill market are: (*i*) popularity of cash credit system in bank lending, and (*ii*) the unwillingness of the larger buyer to bind himself to payment discipline associated with the commercial bill. Among other factors which have prevented growth of genuine bill market are lack of uniformity in drawing bills, high stamp duty on usance or time bills and the practice of sales on credit without specified time limit.

Commercial bills as instruments of credit are useful to both business firms and banks. In addition, since the drawees of the bill generally manage to recover the cost of goods from their resale or processing and sale during the time it matures, the bill acquires a self liquidating character. Finally it is easier for the central bank to regulate bill finance. Keeping in view these considerations the RBI has made efforts to develop a bill market in this country and popularise the use of bills. Its two specific bill market schemes, however, had limited success. The old bill market scheme introduced in January 1952 was not correctly designed to develop a bill market. It merely provided for further accommodation to banks in addition to facilities they had already enjoyed. The scheme had, in fact, provided for obtaining loans on the security of bills rather than for their rediscount. In order to encourage use of bills, the RBI offered loans at a concessional rate of interest and met half the cost of stamp duty incurred by banks on converting demand bills into usance bills. This scheme, however, failed to make any impact. Not satisfied with the old Scheme the RBI introduced a new bill market scheme in November 1970. It has been modified from time to time. The two noteworthy features of this scheme are: (*i*) The bills covered under the scheme are genuine trade bills; and (*ii*) the scheme provides for their rediscounting.

The Certificate of Deposit (CD) Market

A Certificate of Deposit (CD) is a certificate issued by a bank to depositors of funds that remain on deposit at the bank for a specified period. Thus, CDs are similar to the traditional term deposits but are negotiable and tradeable in the short-term money markets. In the mid-1980s, the short-term bank deposit rates were much lower than other comparable interest rates. The Vaghul Committee thus felt that the CD as a money market instrument could not be developed in this country until the situation remained unchanged. The Committee stressed that it was necessary for the introduction of the CD that the short-term bank deposit rates were aligned with the other interest rates. In 1988-89, the RBI, as a corrective measure revised upwards the rate of interest on term deposits of 46 to 90 days. Once this was done ***in March 1989, the RBI introduced CDs with the objective of widening the range of money market instruments and to provide investors greater flexibility in the deployment of their short-term surplus funds.***

The CDs could initially be issued only by scheduled commercial banks in multiples of ₹ 25 lakh (later lowered to ₹ 10 lakh) subject to the minimum size of an issue being ₹ 1 crore. Their maturity varied between three months and one year. In 1993, six financial institutions, *viz.*, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India, Industrial Finance Corporation of India, the Industrial Reconstruction Bank of India, Small Industries Development Bank of India and Export-Import Bank of India were permitted to issue CDs with a maturity period of more than one year and upto three years. CDs are issued at discount to face value and the discount rate is market determined. They are further freely transferable by endorsement and delivery. Banks pay a high interest rate on CDs. Hence, holders of CDs prefer to hold them till maturity and thus secondary activity in CDs has been non-existent. The flexibility of timing and return that can be offered for attracting bulk deposits has made CDs the preferred route for mobilising resources by some banks. The outstanding amount of CDs by banks stood at ₹ 1,638.5 billion as on July, 2018.

The Commercial Paper Market

The Commercial Paper (CP) is a short-term instrument of raising funds by corporates. It is essentially a sort of unsecured promissory note sold by the issuer to a banker or a security house. The issuance of CP is not related to any underlying self-liquidating trade. Therefore, maturity of this instrument is flexible. Usually, borrowers and lenders adopt the maturity of a CP to their needs. Highly rated corporates which can obtain funds at a cost lower than the cost of borrowing from banks are particularly interested in issuing CPs. Institutional investors also find CPs as an attractive outlet for their short-term funds. The Vaghul Committee had strongly recommended the introduction of CPs in the Indian money market. In its observations on this instrument, the Committee had stated, "the issue of commercial paper imparts a degree of financial stability to the system as the issuing company has an incentive to remain financially strong. The possibility of raising short-term finance at relatively cheaper cost would

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provide an adequate incentive for the corporate clients to improve the financial position and in the process the financial health of the corporate sector should show visible improvement."[3]

Following the recommendations of the Vaghul Committee, the CP was introduced in the Indian money market in January 1990. The CP can be issued by a listed company which has a working capital of not less than ₹ 5 crore. With maturity ranging from three months to six months, they can be issued in multiples of ₹ 25 lakh. The company wanting to issue CP is required to obtain every six months a specified rating from an agency approved by the RBI. CPs are freely transferable by endorsement and delivery. According to the RBI's guidelines for the issue of CP, a company has to obtain P2 rating from Credit Rating Information Services of India Ltd. (CRISIL) or A2 rating from Investment Information and Credit Rating Agency of India Ltd. (ICRA). The average fortnightly primary issuance of CPs increased to ₹ 955 billion during 2017-18 from ₹ 807 billion in 2016-17, partly reflecting the substitution of short-term bank credit with market based funding by highly rated corporates on account of lower funding cost relative to bank loan.

Money Market Mutual Funds

A Scheme of Money Market Mutual Funds (MMMFs) was introduced by the RBI in April 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors. As the initial guidelines were not attractive, the scheme did not receive a favourable response. Hence, with a view to making the scheme more flexible, the RBI permitted certain relaxations in November 1995. The new guidelines allowed banks, public financial institutions and also the institutions in the private sector to set up MMMFs. The ceiling of ₹ 50 crore on the size of MMMFs stipulated earlier, was withdrawn. The prescription of limits on investments in individual instruments by MMMF was generally deregulated. Since April 1996, MMMFs are allowed to issue units to corporate enterprises and others.

During 1996-97 the scheme of MMMFs was made more flexible by bringing it on par with all other mutual funds by allowing investment by corporates and others. The scheme was later on made more attractive to investors by reducing the lock-in period from 45 days to 15 days. The scheme was further liberalised in 1997-98 and the MMMFs were permitted to make investments in rated corporate bonds and debentures with residual maturity of upto one year.

Resources mobilised by the MMMFs could earlier be invested exclusively in call/notice money, treasury bills, CDs, CPs, commercial bills arising out of genuine trade/ commercial transactions and government securities having an unexpired maturity upto one year. The prudential measure that the exposure of MMMFs to CPs issued by an individual company should not exceed 3 per cent of the resources of the MMMF has been retained. ***The MMMFs have been brought under the purview of the SEBI regulations since March 7, 2000. Banks are now allowed to set up MMMFs only as a separate entity in the form of trust.***

CHARACTERISTICS OF THE INDIAN MONEY MARKET

In its organisation and development, the Indian money market is not comparable to either the London money market or the New York money market. It suffers from a number of defects of which the following are more prominent:

1. Lack of integration. As already stated, ***the Indian money market is divided into two sectors, viz., the unorganised sector, and the organised sector. As the two sectors are completely separate from each other, their financial operations are quite independent, and whatever goes on in one sector has little effect on the other.***

There is more of competition than co-operation and co-ordination between various components of the Indian money market. For example, co-operative banks compete with the commercial banks, particularly in the countryside. Commercial banks not only compete among themselves but also with the foreign banks. To make the matters worse, the indigenous bankers have absolutely no connections with the RBI. This sorry state of affairs in the banking system is most regrettable in the context of development needs of the country. Moreover, if even after eight decades of the establishment of the RBI its monetary policy has not been found sufficiently effective, then it is the lack of adequate integration in the money market that we shall have to blame.

2. Lack of rational interest rates structure. For a long time, a major defect of the Indian money market was a lack of rational interest rates structure. This was due to lack of adequate co-ordination between different banking institutions. Lately, situation has somewhat improved due to the authority of the RBI. Further, standardisation of interest rates has also introduced some rationality in the structure of interest rates.

3. Absence of an organised bill market. Though both inland and foreign bills are being purchased as well as discounted by the commercial banks, it cannot be said that an organised bill market exists in the country. Only a limited bill market that has been created by the RBI under its schemes of 1952 and 1970 now exists but it has failed to popularise bill finance in this country. Some experts contend

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that the popularity of cash credit and lack of uniformity in commercial bills proved to be serious obstacles to the development of a bill market. Moreover, ***due to the presence of inter-bank call money market, commercial banks never felt the real necessity of an organised bill market.***

4. Shortage of funds in the money market. The Indian money market is characterised by shortage of funds. ***Invariably demand for loanable funds in the money market far exceeds its supply.*** This is attributed to a variety of factors. In the first place, savings are small due to low per capita income. Because of widespread poverty a vast multitude of population has virtually no ability to save. Those of the people who have the ability to save often indulge in wasteful consumption. Secondly, inadequate banking facilities, lack of banking habit among the people and absence of ample and diversified investment opportunities had also contributed in the past to shortage of funds. As in the countryside banking facilities are still lacking, people have little option but to hoard their savings. Failure to mobilise them is a factor that must not be ignored, if the supply of loanable funds is to be augmented. Finally, emergence of a parallel economy and vast amount of black money in the country have also caused shortage of financial resources in the money market. In the recent past, the banking development, particularly the opening of branches of commercial banks in the rural sector and expansion of co-operative banking have, however, improved the mobilisation of funds. This has helped in overcoming the stringency of funds to an extent, but no remedial measures are possible to remove scarcity of loanable funds in the money market caused by the acute poverty of the mass of population.

5. Seasonal stringency of funds and fluctuations in interest rates. India being essentially an agricultural country, farm operations have also some bearing on the demand as well as the supply of funds in the money market. From October to June when farm operations and trading in agricultural produce require additional finance, a monetary stringency is created in the money market. ***Had the money market been sufficiently elastic and the supply of funds could be augmented more or less automatically in response to seasonal rise in the demand, interest rates would have been very much stable.*** But until recently this did not happen in this country.

6. Inadequate banking facilities. Though lately commercial banks have opened their branches on an unprecedented scale, banking facilities in the country are still inadequate. An overwhelming majority of the people in this country is either below the poverty line or just at the subsistence level and does not require any banking facility. At the same time lots of people, particularly those in the countryside whose savings are small, have no access to banking facilities. Mobilisation of the small savings is both difficult and uneconomic, but in an underdeveloped country like ours where every bit of saving is to be used for productive purposes, banking facilities have to be expanded. This problem is now being addressed through various initiatives being undertaken for financial inclusion.

REFORM MEASURES TO STRENGTHEN THE INDIAN MONEY MARKET

The detailed analysis of the Indian money market which we have presented in the foregoing pages clearly suggests that ***the money market in India does not satisfy the criteria of a developed money market. Moreover, in terms of organisation, resources, stability and elasticity it is hardly comparable to the London and New York money markets.*** No doubt among the Third World countries India has one of the most developed banking system. Furthermore, ever since the Banking Regulation Act was passed in 1949 the control of the RBI on the activities of the commercial banks has become quite effective. Nonetheless, the overall organisation of the money market remains underdeveloped.

The RBI and the government have taken various measures to strengthen the Indian money market over the years. Of these, the following are more important:

1. Remitting the stamp duty. In August 1989, the government remitted the stamp duty on usance bills which was considered a major administrative constraint in the use of bill system. However, this measure has failed to induce use of commercial bills. Experts assert that unless effective measures are undertaken to discourage cash credit system, the government's decision to remit the stamp duty alone would not alter the situation in favour of the use of bill system.

2. Deregulation of money market interest rates. With effect from May 1, 1989, the RBI deregulated money market interest rates which proved to be a significant step towards the activation of the money market. This was expected to make interest rates flexible and lend transparency to transactions in the money market. Earlier the call/notice money was subject to interest rate ceiling of 10.0 per cent. Likewise interest rate on inter-bank term money was subject to a ceiling of 10.5-11.5 per cent, and on rediscounting of commercial bills and inter-bank participations without risk was subject to a ceiling of 12.5 per cent.

3. Introducing new money market instruments. Over the past two-and-a-half decades, four major money market instruments have been introduced. These are 182-day treasury bills, 364-day treasury bills, Certificates of Deposits (CDs) and Commercial Paper (CP). 182-day

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treasury bills were systematically promoted by the Discount and Finance House of India and were the first security sold by auction for financing the fiscal deficit of the Central government. The Discount and Finance House of India also developed a secondary market in these bills and they became popular with the banks. In 1992-93, it was decided to introduce 364-day treasury bills and the auctions of 182-day treasury bills were discontinued. 182-day treasury bills were, however, reintroduced in May 1999. Like 182-day treasury bills, 364-day treasury bills can be held by the commercial banks for meeting Statutory Liquidity Ratio.

CDs gained a considerable market in 1996-97. The volume of outstanding CDs rose from ₹ 63.85 billion on January 6, 1995 to ₹ 208.15 billion on July 5, 1996. However, due to improvement in the liquidity conditions later on, the outstanding amount of CDs steadily declined and was as low as ₹ 7.64 billion on November 2, 2001. The outstanding amount of CDs issued by banks stood at ₹ 1,226 billion as on July 21, 2017.

CPs as money market instrument are now more than twenty years old. The Indian CP market is driven by the demand for CP by scheduled commercial banks which, in turn, is determined by bank liquidity. The secondary activity is subdued in the Indian CP market due to most investors' preference to hold the instrument on account of higher risk-adjusted return relative to those of other instruments. The outstanding CPs as on July 15, 2017 stood at ₹ 3,584 billion. The average fortnightly primary issuance of CPs increased to ₹ 955 billion during 2017-18 from ₹ 807 billion in 2016-17, partly reflecting the substitution of short-term bank credit with market based funding by highly rated corporates on account of lower funding cost relative to bank loan.

4. Introduction of repos and reverse repos. An important development in the government securities market is the introduction of repos and reverse repos. ***These are instruments used for short-term liquidity management.*** Repo is the rate at which banks borrow from the Reserve Bank while reverse repo is used to drain excess cash lying with the banks. An increase in these rates signals a rise in interest rates. To tackle the problem of high inflation in the economy in some of the recent years, the Reserve Bank has hiked these rates on a regular basis. In fact, over the period of March 2010 to October 2011, it increased these policy rates by as much as thirteen times.

In its Monetary Policy for the year 2011-12 announced on May 3, 2011, ***the Reserve Bank announced its decision to shift towards a single policy rate — the repo rate.*** Thus, repo rate is now the single independently varying rate. The reverse repo rate was pegged at 100 basis points (bps) below the repo rate. ***RBI also instituted a new marginal standing facility (MSF) from which scheduled commercial banks can borrow overnight funds*** (upto one per cent of net demand and time liabilities) at a rate 100 bps above the repo rate. This created a 200 basis points corridor with repo at the centre, reverse repo 100 basis points below and MSF 100 basis points above the repo. In its Monetary Policy Statement issued on April 5, 2016, RBI reduced the corridor to 100 points. This was reduced further to 50 basis points in the Monetary Policy Statement issued by RBI on April 6, 2017. In other words, ***reverse repo rate is now pegged at 25 basis points below the repo rate and the MSF at 25 basis points above the repo rate.*** The repo rate was fixed at 6.25 per cent on June 6, 2018. Repo rate is presently 5.75 per cent. Consequently, the reverse repo rate became 5.50 per cent. MSF is presently 6.0 per cent. Since bank rate is aligned to the MSF, it also stands at 6.0 per cent.

5. Setting up of the Discount and Finance House of India. The Discount and Finance House of India (DFHI) was set up on April 25, 1988. Its major function is to bring into the fold of the Indian money market the entire financial system comprising of the scheduled commercial banks, foreign banks, co-operative banks and all-India financial institutions in the public and private sectors, so that their short-term surpluses and deficits are equilibrated at market-related rates/prices through inter-bank transactions in case of banks and through money market instruments in the case of banks and others. In DFHI operations, the emphasis is placed on a high turnover in the money market instruments rather than on being their repository.

6. Introducing money market mutual funds. Money market mutual funds (MMMFs) were introduced in India in April 1991. MMMFs provide an additional short-term avenue to investors and bring money market instruments within the reach of individuals. The portfolio of MMMFs consists of short-term money market instruments.

7. Developing call/notice money market. The call/notice money market was mainly an inter-bank market until 1990. Only the Unit Trust of India and the Life Insurance Corporation were allowed to operate as lenders since 1971. During the 1990s, the RBI's policy relating to entry into the call/notice money market was liberalised to provide more liquidity despite the recommendation of the Vaghul Committee that the call money market should be restricted to banks. As of now, broadly speaking, banks and primary dealers (PDs) are operating as both lenders and borrowers, while a number of non-bank financial institutions and mutual funds are operating only as lenders.

8. Removing constraints on development of the term money market. The term money market in India remained dormant for a long period of time. Statutory pre-emptions on inter-bank liabilities, cash credit system of

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financing, the regulated interest rate structure, the high degree of volatility in the call money rates, availability of sector-specific refinance, the scarcity of money market instruments of varying maturities and the inadequate asset liability management (ALM) discipline among banks were the factors that inhibited the development of the term money market. Most of these constraints have been gradually removed by the RBI in recent years and as a result there is some activity in the term money market.

9. Sector-specific refinance facilities. Refinance is used by central banks to meet liquidity shortage in the system, to control monetary and credit conditions and direct credit to selective sectors. The RBI has used in the past a number of sector-specific refinance facilities of which export credit refinance and food credit refinance were the most prominent.

Outlook for the Future

A review of money market developments in India and its current state show that, though a late comer, India is not lagging behind in any significant manner. According to Y.V. Reddy, "however, ***while a base has been created with a variety of products in the money market, the market has not acquired the required depth in terms of both volume and liquidity.***"[5] It is widely expected that the institutional and other reforms will provide the necessary depth in future. With that the Indian money market will get integrated with debt and foreign exchange markets and may pave the way for the RBI's increased use of indirect tools of monetary regulation.

NOTES

1. Y. Venugopal Reddy, *Monetary and Financial Sector Reforms in India* (UBS Publishers and Distributors Ltd., New Delhi, 2000), p. 27.
2. Kunal Sen and Rajendra R. Vaidya, *The Process of Financial Liberalisation in India* (Delhi, 1997), p. 68.
3. The Reserve Bank of India, *Report of the Working Group on the Money Market* (The Vaghul Committee Report) (Mumbai, 1987), p. 20.
4. Reserve Bank of India, *Handbook of Statistics on Indian Economy* 2016-17 (Mumbai, 2017), Table 216, p. 345.
5. Y. Venugopal Reddy, *op. cit.*, p. 296.

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46 Chapter

COMMERCIAL BANKING IN INDIA

At the time of Independence, Indian banking system was not sound. There were hundreds of private banks under unscrupulous managements. Hence, ***in 1949 two major actions were taken which were very important from the point of view of structural reforms in the banking sector. First, the Banking Regulation Act was passed. It gave extensive regulatory powers to Reserve Bank of India (RBI) over the commercial banks. Another development of no less importance was the nationalisation of the RBI.*** These two major developments in the immediate post-Independence period proved to be the turning points in India's commercial banking.

This chapter devoted to a discussion of commercial banking in India, considers the following issues:

- Banking developments during the pre-nationalisation phase (1949-69)
- Nationalisation of banks in 1969 and its rationale
- Banking structure in India
- Expansion of banks during the post-nationalisation phase
- Deposit mobilisation and bank lending
- Evaluation of banking since nationalisation
- Banking sector reforms
- Indian banking: Concerns and challenges for future.
- Appendix to Chapter 46: Payment Banks and Small Finance Banks

BANKING DEVELOPMENTS — 1949-69

In the two decades following the enactment of the Banking Regulation Act, 1949, the Indian banking system developed in many respects. It not only grew geographically, but also structurally and functionally. The number of scheduled banks, however, decreased from 94 to 76 over the period. A significant change that occurred in this period was a steady decline in the importance of the non-scheduled commercial banks. ***The Banking Regulation Act provided extensive regulatory powers to the RBI and with that it became possible for it to carry out various structural reforms in the banking system.***

Judged on the basis of deposit mobilisation, commercial banks made considerable progress in this period. Deposits of the scheduled banks registered spectacular increase. The other notable features in deposit growth of the period were the higher rate of growth in time deposits relative to demand deposits and the rise in the number of personal accounts relative to business accounts.

The establishment of the State Bank of India in 1955 and the creation of the State Bank group by nationalising eight regional banks in 1960 allowed scope for a new experiment in the Indian banking. Under a statutory obligation, these banks opened new offices in semi-urban and rural areas and approached those sections of people which were hitherto never served by the modern banks.

The period also witnessed a change in the lending policy of commercial banks. For long the major part of their credit had gone to commerce and large and medium-scale industries. During the period under reference not only the commercial bank credit to industries increased, the banks also developed an interest in term lending.

Finally, in order to provide some protection to the depositors, an important step in the form of establishment of the Deposit Insurance Corporation was undertaken on January 1, 1962. The deposit insurance is very helpful in mobilisation of deposits, as it enhances confidence of the people in banks. Its need was long felt in this country, particularly during the periods of large-scale bank failures.

NATIONALISATION OF BANKS

In a free enterprise economy, commercial banks operate like any other business and are mainly concerned with the maximisation of their private gains. Lacking any social purpose they often channelise funds to business units in which the management has its interest and thus contribute in a big way to growth of monopolies and concentration of economic and political power, while overall economic activity suffers because priority sectors/ industries fail to get adequate funds. It was long felt that so much freedom to commercial banks was not in harmony with the concept of the socialist pattern of society which

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had formally become the accepted goal of the Indian society. The Hazari Committee in its report on 'Industrial Planning and Licensing Policy' submitted to the Planning Commission on September 14, 1967, clearly underlined this point when it stated, "It would be difficult to undertake credit planning unless the linked control of industry and banks in the same hands is snapped by nationalisation of banks."[1] The government, however, decided in favour of social control.

The social control phase, however, turned out to be transitory. Expectations of the government that the social control would remove objectionable banking practices of the past and would give a new sense of purpose to the banks for future were belied. Having realised that nothing short of nationalisation would solve the malady, the government took a bold decision to bring under its direct control a substantial segment of the banking system.

Rationale for Nationalisation

On July 19, 1969, fourteen commercial banks with deposits worth ₹50 crore or more were nationalised. In her broadcast address of July 19, 1969, on bank nationalisation, Prime Minister Mrs. Indira Gandhi stated that nationalisation was meant for an early realisation of the objectives of social control which were spelt out as, ***"(i) removal of control by a few, (ii) provision of adequate credit for agriculture and small industry and export, (iii) giving a professional bent to management, (iv) encouragement of a new class of entrepreneurs, and (v) the provision of adequate training as well as terms of service for bank staff".***

We shall now state some more widely known criticisms of privately owned commercial banks. These are as follows:

1. ***Control of big business houses over commercial banks invariably results in concentration of wealth and economic power.*** Until their nationalisation, all major banks in India were controlled by one business house or the other or jointly by a few of them. Both the Mahalanobis Committee on the Distribution of National Income in India and the Vivian Bose Commission had clearly exposed the nexus between the banks and the big business. The directors of banks often had close connections with numerous companies of big business houses and they used their positions to finance the companies in which they had interests.

2. ***Claims of agriculture for loans were always turned down in the past by the commercial banks on the plea that agricultural credit did not fall within their purview.*** Before their nationalisation, the lending policy of the commercial banks was highly discriminatory. Their anti-small borrower bias was obvious, and they generally ignored the claims of small industrialists in respect of credit. Commercial banks also violated the priorities laid down in the plans while granting loans to various industries. Many industries, which nowhere figured in the priority list got large funds, whereas the priority sectors starved for resources.

3. ***Credit policy of the commercial banks until their nationalisation encouraged some socially undesirable activities, such as hoarding, black-marketing, etc.*** Anti-people elements like hoarders and black marketers borrowed heavily from the banks to corner the supplies of essential commodities, including foodgrains.

4. ***Prior to their nationalisation, commercial banks had shown virtually no interest in establishing offices in semi-urban and rural areas.*** More and more branches were set up in cities by different banks resulting in concentration of banking facilities and unwarranted competition between them. Commercial banks' lack of interest in opening branches in the countryside was primarily due to lack of profitability. Nationalisation of commercial banks was the only answer to this problem.

After nationalisation, the following two main objectives were laid down for the public sector banks: ***(i) mobilisation of deposits through a massive programme of branch expansion particularly in the unbanked rural areas, and (ii) ensuring adequate financial assistance to the priority sectors of the economy.***

BANKING STRUCTURE IN INDIA

Scheduled commercial banks in India comprise 21 public sector banks, 21 private sector banks, and 45 foreign banks. ***In terms of business, the public sector banks have a dominant position as they account for 70 per cent of banking assets***. As at end-March 2017, public sector banks had 91,549 branches all over the country. In recent years in order to meet the credit requirements of the weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs, the regional rural banks have been set up in different parts of the country. As at end-March 2017, their branches numbered 21,343. In terms of business they, however, remain very much less important than the traditional commercial banks. The foreign scheduled banks operate mostly in big cities and their number of branches in the whole country is just 285. Other scheduled commercial banks are private sector banks and their branches numbered 24,890 as at end-March 2017. As a whole, India now has a far more developed and integrated banking system than that at the time of Independence.

The State Bank of India and Its Associate Banks

On the recommendation of the Rural Credit Survey Committee, the Imperial Bank of India was converted into the State Bank of India on July 1, 1955. Its 92 per cent

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shares were acquired by the RBI, and thus it had the distinction of becoming the first State owned commercial bank in the country. Among the factors which guided the establishment of the State Bank of India the main consideration was that the country should have a big commercial bank committed to national purpose and should take banking to the countryside even if initially it was not a commercially viable proposition. In view of this necessity, the State Bank was required to function as a development agency besides performing the traditional functions of a commercial bank.

In 1959, the State Bank of India (Associate Banks) Act was passed and this paved the way for creating the State Bank Group. State Bank of Hyderabad, State Bank of Bikaner and Jaipur, State Bank of Mysore, State Bank of Patiala, and State Bank of Tranvancore constituted the State Bank Group. On April 1, 2017, the Associate Banks were merged with the State Bank of India. Bharatiya Mahila Bank was also merged with the State Bank of India. ***With these mergers, State Bank of India joined the league of top 50 banks globally in terms of assets.*** The consolidated balance sheet of the merged entity rose to about ₹ 32 lakh crore, deposit base to more than ₹ 26 lakh crore and advances level to about ₹ 18.75 lakh crore. The merger pushed up the number of branches of State Bank of India to about 24,000 and the number of ATMs to about 59,000 across the country.

Other Nationalised Banks

A second category of public sector banks is of twenty commercial banks, of which fourteen were nationalised on July 19, 1969. Each one of these fourteen banks had deposits of ₹ 50 crore or more. This step changed the very complexion of the banking structure in the country. The nationalisation was justified by the government on the ground that the major banks could not be any more allowed to remain captive organisation of the big business. Their policies should be inspired by the larger social purpose and be in accordance with the national priorities and objectives. Hence, a fundamental shift in their approach was witnessed in the post-nationalisation phase. The banking system in this period became an instrument of development. The Lead Bank Scheme formulated in December 1969 played a significant role in transforming these profit maximising institutions of yesteryears into catalysts of local development.

After nationalisation of 14 banks, there was rapid expansion of branch network. ***On April 15, 1980, six more private owned commercial banks were nationalised.*** The purpose, as it has been stated by the government, was "to control the heights of the economy, to meet progressively and serve better the needs of the development of the economy and to promote welfare of the people, in conformity with the policy of the State". With the nationalisation of six more banks, the share of private sector in the entire banking declined to just 9 per cent. In 1993, New Bank of India merged with Punjab National Bank. As a result, ***the number of public sector banks other than the State Bank of India and its associates declined to nineteen.*** IDBI was converted into a public sector bank – IDBI Bank Ltd. – in October 2004 raising the number of public sector banks other than the State Bank to 20.

Regional Rural Banks

The nationalisation of major fourteen banks though successful in many respects could not do much to solve the problem of rural indebtedness. The grip of moneylenders remained tight in the countryside and rural indebtedness was widespread. Therefore, a new type of banking institution called Regional Rural Banks was conceived. The Working Group on Rural Banks (Chairman: M. Narasimham) recommended the setting up of these banks as part of a multi-agency approach to rural credit. These banks known as regional rural banks have been set up under an Act of 1976.

A regional rural bank is sponsored by a public sector bank which also subscribes to its share capital. Assistance is also given in the form of managerial personnel. The regional rural banks, though operating as a subsidiary of one or the other public sector bank, in terms of ownership are predominantly government undertakings. The regional rural banks meet the credit requirements of weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs. As on June 30, 2006, there were 196 regional rural banks with a network of 14,500 branches in the country. Ninety per cent of these have been opened in rural areas and unbanked centres. Since regional rural bank was an innovation, its viability was in doubt. As such, a study was conducted by the RBI. The study concluded that "on an average regional rural bank would require about six years and a network of 70 branches to become viable. For this it is necessary that it reaches an outstanding loan business level of ₹ 8 crore and also has a margin of about 5 per cent between its borrowing and lending rates." Over the years, regional rural banks accumulated massive losses and the recovery position of their loans was bad. Accordingly, the government allowed them to grant loans to non-priority sectors as well. This has enabled these banks to improve their financial performance. The process of consolidation and amalgamation of RRBs is also taking place. As a result of amalgamation, the number of RRBs has come down to 56. The number of branches of these banks as at end-March 2017 was 21,343.

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Private Sector Commercial Banks

Now relatively small scheduled commercial banks and seven newly established private banks with a network of 24,890 branches are operating in the private sector. In terms of branches and also the business done by them, most of the old private sector banks are much smaller than both nationalised banks and foreign banks and thus their role in the financial system of the country is just marginal. Recently having realised that over the years competitive efficiency has suffered in the banking sector, setting up of new private sector banks is being encouraged. The total number of banks in the private sector is presently 21 (the practice of classifying private sector banks into 'old private sector banks' and 'new private sector banks' has been discontinued).

Foreign Banks

At end-March 2017, the country had 45 foreign banks with 285 branches located mainly in big cities. Except a few which have opened their offices in India recently majority of these banks have been operating in this country for a long time. Their standing, in fact, in the country is even longer than that of most of the leading scheduled banks of this country. Apart from financing of foreign trade, these banks had made significant contribution to the development of banking habits in the country as they have performed all the functions of a commercial bank, including the acceptance of deposits and lending of funds for trade and commerce. In financing the foreign trade, foreign banks had virtual monopoly for a long period of time.

New Norms for Foreign Banks. On November 6, 2013, the Reserve Bank unveiled a new set of far-reaching regulations which will enable foreign banks to compete on a nearly equal footing with the domestic banks. ***A foreign bank will now have nearly the same freedom as a domestic bank in opening branches if it choose to incorporate locally.*** To incorporate locally, a foreign bank will need to start out with a capital base of ₹ 500 crore. Half the directors of the bank should be of Indian origin and at least one-third should be Indian nationals. The foreign banks would also have to lend to farmers and small-scale industries and they would also face the same restrictions on CEO compensation that Indian private banks are subject to.

RBI has said that it may force some of the foreign banks to incorporate locally if it feels that rules in its home country require the bank to favour depositors back home over depositors abroad. Foreign banks which account for 0.25 per cent of banking assets in India may also be forced to convert into a local entity. Domestic incorporation may also be made mandatory for banks that do not have adequate disclosure requirement in their home jurisdiction, or those that have a 'complex structure' or are 'very closely held.' RBI has permitted wholly owned subsidiaries to enter into merger and acquisition (M&A) transactions with any private bank in India, subject to the overall foreign investment limit of 74 per cent. Foreign banks creating subsidiaries have been permitted to acquire local banks.

RBI has said that it will cap the entry of new wholly owned subsidiaries of foreign banks when the capital and reserves of the foreign banks (or wholly owed subsidiaries and foreign bank branches) in India exceed 20 per cent of the capital and reserves of the banking system.

EXPANSION OF BRANCHES DURING THE POST-NATIONALISATION PHASE

The post-nationalisation period has witnessed an unprecedented growth in the branch network of commercial banks. The banks in this period have given particular attention to providing banking facilities in underbanked regions and in relatively developed regions at unbanked centres. This was due to the fundamental shift in the approach after the nationalisation. With the government takeover of all major commercial banks the banking system was made to function as an instrument of development. Prior to nationalisation, this was not possible.

'Lead Bank' Scheme and Branch Expansion

The area approach in respect of bank financing proposed by the Gadgil Study Group towards the end of 1969, culminated in the Lead Bank Scheme. It had the backing of Nariman Committee also. The Governor of the Reserve Bank had appointed a Committee of Bankers under the Chairmanship of F.K.F. Nariman in August 1969 to prepare a programme for creating adequate banking facilities, particularly in districts/regions where such facilities were lacking at the time of nationalisation. The Committee favoured a co-ordinated approach and was of the view that the banks should be allotted particular districts where they would take the lead in surveying the scope for banking development, particularly expansion of credit facilities.

The Reserve Bank accepted the recommendations of the Nariman Committee and prepared the 'Lead Bank' Scheme. Under the 'Lead Bank' Scheme districts were allotted to the State Bank Group, 14 nationalised banks and 3 private Indian banks.

The Lead Bank was assigned a major development responsibility in the district allotted to it. To begin with, it was expected to familiarise itself with socio-economic conditions prevailing in the district. For this purpose, it was required to undertake a survey of a techno-economic nature. It was expected that from these surveys Lead Bank would

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be able to collect useful information about resource endowment, economic and social infrastructure, pattern of different types of production, possible development schemes and obstacles to development. The surveys could also make it possible to assess deposit potential and credit gaps. The Lead Bank had to identify centres for banking development in the light of this information.

After completing the surveys for all the districts of the country, the district level consultative committees for co-ordinating banking development activities were constituted by the Lead Banks. The Lead Banks prepared phased programmes for banking development which they implemented with the co-operation of other commercial banks and other financial institutions. The execution of this programme has not been the exclusive responsibility of the Lead Bank.

Progress in Branch Expansion

The progress in branch expansion has been spectacular since the nationalisation of banks in terms of number of branches, coverage of rural and unbanked areas, removal of regional imbalances, etc.

1. The numerical increase in bank offices. There was a massive expansion of bank offices after the nationalisation of 14 banks in 1969 and the 'Lead Bank' Scheme has played a significant role in it. During the first decade and a half of bank nationalisation, there was phenomenal expansion in branch network. Branches expanded at nearly 2,400 per year. Thereafter, offices of commercial banks increased at an annual rate of 850. Of the new offices opened, the State Bank Group and the nationalised banks accounted for more than 92 per cent.

2. Branch opening in rural and unbanked areas. Apart from the numerical increase in the offices of commercial banks, there has been a qualitative change in branch expansion programme ever since the banking sector has been brought under public ownership. ***Until the nationalisation, there was an obvious urban bias in the dealings of commercial banks, and as such they were totally opposed to the idea of moving into rural areas. Their favourite areas of operation were industrial and trade centres.*** However, after the nationalisation of 14 banks, a deliberate policy was pursued to take banking to rural and less developed areas. This change in approach resulted in an improved dispersal of banking facilities. As against 22.2 per cent bank offices located in rural areas in June 1969, there were 35.3 per cent bank offices in these areas as at end-March 2017.

3. Attempt to correct regional imbalances. Regional imbalances in the field of banking facilities had existed in the country for a long time. The Gadgil Committee had pointed out in its report that the banking facilities were far greater in relatively developed States and even within these States they were concentrated in economically advanced pockets. This kind of banking development is inevitable in a market economy. The Committee, however, underlined the need for rectifying these regional imbalances. In the post-nationalisation period, planned attempts were made to augment banking facilities in relatively backward States. As a result, branch expansion was faster in the States like Assam, Odisha, Bihar, Madhya Pradesh and Uttar Pradesh than in developed States like Maharashtra, Gujarat and Tamil Nadu. This has progressively reduced regional inequalities in banking facilities, but they can never be wiped out completely unless the level of economic development is the same everywhere.

DEPOSIT MOBILISATION

The banking sector has played an increasingly important role in the financial intermediation process by mobilising savings in the form of deposits. A major turning point in this context was the nationalisation of 14 major banks in July 1969. While growth in deposits in the pre-nationalisation phase (1951-52 to 1968-69) was 9.5 per cent per annum, it shot up to 19.2 per cent per annum over the period 1969-70 to 1983-84. During the period of next two decades — 1984-85 to 1994-95 and 1995-96 to 2004-05, it was 18.4 per cent per annum and 15.7 per cent per annum respectively. Over the period 2005-06 to 2007-08, bank deposits increased at a still higher rate of 21.4 per cent per annum.[2] Because of the robust growth in the post-nationalisation phase, ***the bank deposits rose to as high as ₹ 1,14,260.5 billion at end-March 2018 (in July 1969, they were just ₹ 43.4 billion).*** This phenomenal rise in bank deposits was partly due to inflationary increase in the quantity of currency, partly due to the rise of national income and partly due to the deposit mobilisation efforts of the commercial banks.

Growth Pattern of Deposits

Data on time and demand deposits are not comparable for the entire period. Since a part of the savings deposits which was earlier included in demand deposits is now being counted as time deposit, comparison over time becomes difficult. But this much is clear even without making necessary adjustments to make data comparable over the period that the rate at which time deposits have grown during the last forty years is distinctly higher than the rate of growth in demand deposits. As a result, time deposits amounted to ₹ 1,00,557.7 billion while demand deposits were only ₹ 13,702.8 billion as at end-March 2018 (thus, the share of time deposits in aggregate deposits was 88.0 per cent while

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the share of demand deposits was only 12.0 per cent). This is probably because the commercial banks have developed banking habit among new sections of society and in the process, have succeeded in getting their savings. As pointed out earlier, a notable feature of banking development during the post-nationalisation period has been the spread of banking in the unbanked rural areas. The deposits mobilised by the rural branches have, therefore, increased not only in absolute terms but also in relative terms. Moreover, fixed and savings deposits have been more popular in rural areas. Deposits in semi-urban and urban areas have also increased but growth at these centres is not as spectacular as in rural areas. However, there is a visible shift towards fixed and savings deposits.

Metropolitan centres all over the world have attracted commercial banks on a massive scale and India has not been an exception to this general rule. Until the nationalisation of 14 major banks, eight metropolitan cities (Mumbai, Kolkata, Chennai, Delhi, Hyderabad, Ahmedabad, Bangalore and Kanpur) accounted for more than fifty per cent of the deposits of commercial banks. However, as a result of great emphasis placed on a wider dispersal of banking facilities during the post-nationalisation period there has been a steady change in the relative importance of deposits in various areas and the metropolitan centres now account for less than forty per cent of aggregate deposits. But one noticeable fact about these centres is that rate of growth in deposits has been quite high. Apart from this fact, there has been a marked rise in the average number of deposits per office. These facts clearly show the extraordinary potential that metropolitan centres offer for deposit mobilisation.

State-wise Distribution of Deposits

Amount of deposit mobilisation in any State depends very much on its level of economic development, particularly industrialisation. Growth of industries and trade determines the richness of the community and also the capacity of the people to save. Size of the population is not a major factor. It contributes only when the condition of development is already satisfied. In view of this fact, it is not at all surprising that ***Maharashtra leads all other States in terms of deposit mobilisation. In fact, it accounts for almost one-fourth of the aggregate deposits received by the banks in the whole country.*** If we consider the four developed States of Maharashtra, Gujarat, Delhi and Tamil Nadu together, we find that their share in aggregate deposits was 45.5 per cent at end-March 2015. Although Punjab and Haryana are also developed States, yet their share in aggregate deposits was only 5.4 per cent. This is basically due to the small size of these States and the predominance of agriculture in them. Small States like Sikkim, Mizoram, Arunachal Pradesh, Manipur, Nagaland and Tripura are still economically backward and their capacity to mobilise bank deposits is very little. However, in terms of percentage growth during the post-nationalisation period relatively less developed States have done better. This is perhaps the result of the spread of banking facilities to less developed pockets in backward States.

BANK LENDING

Of all the functions of commercial banks, lending of funds is certainly the most important function. While performing this function banks provide working capital to commerce and industry. In India, only after the nationalisation of 14 major banks substantial amounts of loans have been given for agricultural operations.

Growth of Bank Lending

Total advances (bank credit) of all scheduled commercial banks in India stood at ₹ 86,254 billion as at end-March 2018. Since nationalisation of 14 major banks there has been a spectacular rise in bank credit. In July 1969 it was only ₹ 34 billion. Over a period of 48 years, bank credit has steadily increased. The two major factors which contributed to this phenomenon were the inflationary expansion in the supply of money and massive deposit mobilisation. It is noteworthy that ***in the recent past bank lending did not increase as fast as the deposits. As a result, credit-deposit ratio which was 80.8 per cent on March 30, 1976 declined to 72.2 per cent as at end-March 2010. It rose to 77.7 per cent as at end-March 2016 but fell again to 72.9 per cent as at end-March 2017. It was 75.5 per cent at end-March 2018.***

Sectoral Deployment of Credit

Today sectoral deployment of bank credit is qualitatively different from what it was at the beginning of the plan era in this country. In 1951 commerce and industry accounted for 36 and 34 per cent of the bank credit respectively. Agriculture figured nowhere in the credit scheme of commercial banks. With the progress of economic planning and rising accent on industrialisation, the scenario changed. In March 1968, large and medium industries accounted for 60.6 per cent of aggregate credit; the commerce having been relegated to a secondary position. Agriculture even in this year accounted for a mere 2.2 per cent of the total bank credit. Commercial banks' rejection of agriculture's claim for credit was perhaps on account of the categorical position taken by the Gorwala Committee in this regard. The Committee in its Survey Report (All India Rural Credit Survey Report) had firmly stated, "we feel justified in rejecting commercial banks generally as an agency suitable for inclusion with the integrated scheme of rural credit".

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After the nationalisation of banks, there was a radical change in the credit policy of public sector banks, and the relatively small private banks were left with no choice but to follow them. ***The new policy placed special emphasis on credit to priority sectors including agriculture and small-scale industries. As a result, shares of other sectors in bank credit declined over the period.*** As at end-March 2018, the outstanding non-food gross bank credit was ₹ 76,884 billion of which ₹ 23,257 billion (*i.e.*, 30.2 per cent) had gone to industries. Advances to agriculture stood at ₹ 10,302.2 billion while advances to micro and small-scale industries were ₹ 3,736 billion.

Advances to the Priority Sectors

Until the mid-1960s, the beneficiaries of bank credit were the people having direct or indirect control over the administration of banks. Hence agriculture, small-scale industries and other priority sectors failed to get the required bank credit in spite of their importance in the country's development planning. Towards the end of 1965, a beginning was made to mould the credit policy of the commercial banks so as to make it consistent with the planning policies. With this clear objective in perspective a scheme known as 'Credit Authorisation Scheme' was introduced in November 1965. Later on, the scheme of social control over banking was introduced under which banks were required to allocate bigger amount of credit to the priority sectors. In February 1968, the National Credit Council was set up with a view to provide a forum for deciding priorities on an all-India basis. These measures were soon found inadequate and the government thus resorted to nationalisation of 14 major banks. The extension of credit to small borrowers in priority sectors was in fact the foremost aim of nationalisation and, therefore, its magnitude is considered to be the real test of its success.

In the past, excepting to plantations, very little bank credit was made available to agriculture. Aggregate finance to agriculture amounted to ₹ 1.62 billion at the end of June 1969. Since then, bank finance to agriculture has increased considerably which is evidently clear from the fact that the outstanding bank credit to agriculture as at end-March 2018 was ₹ 10,302.2 billion. The number of beneficiaries also increased considerably. The share of agriculture in ANBC (adjusted net bank credit) was 17.8 per cent as at end-March 2017 as against the target of 18.0 per cent.[3] Importance of small-scale industry in this country has been underlined from time to time on account of its employment potential. Its survival and growth, however, depends largely on the availability of finance from the organised banking sector. In view of this imperative, bank credit to this sector has been provided in steadily increasing quantity. The share of micro and small enterprises in ANBC as at end-March 2017 was 13.9 per cent. Other priority sectors (like road and water transport operators, retail traders and small businessmen, professional and self-employed persons etc.) have also benefited considerably from nationalisation.

In an effort to widen and make the directed credit system more effective, the guidelines on lending to the priority sector were revised first on April 30, 2007 and then on April 23, 2015. The April 30, 2007 guidelines defined the broad categories of the priority sector as: (*i*) Agriculture (direct and indirect finance), (*ii*) Small enterprises (direct and indirect finance), (*iii*) Retail trade, (*iv*) Micro-credit, (*v*) Education loans, and (*vi*) Housing loans. The overall target for priority sector was kept at 40 per cent of ANBC (which included 18 per cent for agriculture). As against this, achievement at end-March 2017 was as follows – 39.5 per cent for public sector banks, 42.5 per cent for private sector banks and 36.6 per cent for foreign banks. The new guidelines issued on April 23, 2015 have revamped priority sector lending norms. Now, loans to sectors, such as social infrastructure, renewable energy and medium enterprises will also be treated as priority sector lending. ***The revised categories of the priority sector are: (i) Agriculture (the distinction between direct and indirect agriculture has been done away with), (ii) Micro, Small and Medium Enterprises, (iii) Export credit, (iv) Education, (v) Housing, (vi) Social infrastructure, (vii) Renewable energy, and (viii) Others. The overall target for priority sector lending has been kept unchanged at 40 per cent of ANBC. The target for agriculture also remains unchanged at 18 per cent of ANBC (within the 18 per cent target for agriculture, target of 8 per cent has been kept for small and marginal farmers).***

EVALUATION OF BANKING SINCE NATIONALISATION

The period since bank nationalisation is of great importance from the point of view of banking development as the size and the reach of the banking system registered spectacular progress in this period. ***Aggregate bank deposits have risen from 11 per cent of GDP in July 1969 to 71 per cent of GDP as at end-March 2017.*** The total number of branches also rose considerably from 8,262 in 1969 to 1,38,945 as at end-March 2017. Of these, 35.3 per cent are now in rural areas as against less than 22.5 per cent at the time of nationalisation of major banks in 1969. ***Opening of rural branches has improved mobilisation of savings in the rural sector. Presently rural deposits account for about 15 per cent of total deposits. Since bank nationalisation in this country, priority sector credit has also increased considerably*** (it was 39.5 per cent for public

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sector banks, 42.5 per cent for private sector banks and 36.9 per cent for foreign banks as at end-March 2017).[4] Over the years, development of banking has been faster in relatively less developed regions of the country, and as a result regional disparities have declined and the concentration of banking business is now less.

The performance of the banking system in India since the nationalisation of 14 banks is definitely impressive. The achievements of the banking sector as stated above are, however, nowhere near meeting the needs of the economy. Since development oriented policy of the banks eroded their profitability, it was used by the Narasimham Committee to criticise directed credit programmes. The Committee argued that ***the directed investment and directed credit programmes together with mounting expenditures completely eroded the profitability of the banks.*** The fact is that in the later post-nationalisation phase, overall profitability of the banks was either low or even negative and their non-performing loans both as a percentage of total advances and as a percentage of assets were fairly high and their financial position was extremely weak.

Commercial banks during the post-nationalisation phase had a societal purpose and thus directed credit programme was pursued, though it eroded profitability of the commercial banks. Banks were not regarded as profit maximising institutions. Hence, it is wrong to assess their performance in the terms of their profitability. Nevertheless ***in the process of ignoring profitability considerations, many commercial banks lost their financial viability and by the end of 1980s, it had become clear that further neglect of profitability considerations could ultimately send banking institutions to their bankruptcy.***

Causes of Low Profitability in Nationalisation Phase

The major causes of the low profitability of banks during the phase of nationalisation were as follows:

1. Directed investment. Under the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 there are provisions whereby it is possible to regulate monetary expansion to ensure price stability. But these very provisions if misused are likely to create problems in the banking sector. In fact, this precisely happened after the nationalisation of banks, particularly during the 1980s. The rise in fiscal deficit since 1980-81 exercised pressure on the government to borrow from both RBI and non-RBI sources. The government borrowing from the RBI generated inflationary pressure which was countered by raising the cash reserve ratio (CRR). The pressure to borrow from non-RBI sources resulted in increases in the statutory liquidity ratio (SLR). This implied that the banks were required to make heavy investments in government securities and the securities of public sector financial institutions. ***The return on the government securities is less than the market lending interest rates. Moreover, the RBI pays a relatively lower interest on the cash reserve kept by the banks with it under CRR. At its peak, the total directed investment reached 63.5 per cent of incremental bank deposits which severely undermined the profitability of the commercial banks.***

2. Directed credit programmes. A major objective of bank nationalisation in 1969 was to make bank credit available to agriculture, small-scale manufacturing units, export sector, food procurement operations, transporters and so on (often designated as priority sectors) on relatively soft terms. This system of directed bank credit was expected to contribute to economic growth as well as social justice. Probably to an extent some success was achieved in these directions. However, the cost of this exercise was quite high. There were serious departures from the principles of sound banking on account of shift from security-oriented credit to purpose-oriented credit. ***There was considerable deterioration in the quality of loan portfolio on account of fixation of targets for priority sectors lending, neglect of qualitative aspect of lending, degeneration of socially oriented credit into irresponsible lending and accumulation of overdues.*** Over the years, the most serious damage to the banking system has been done by the political and administrative interference in the credit decision-making. Commenting on this state of affairs the Narasimham Committee on the Financial System remarked, "In many cases of IRDP lending, banks have virtually abdicated their responsibilities in undertaking need-based credit assessment and appraisal of potential viability and instead have tended to rely on lists of identified borrowers prepared by government authorities."

3. Subsidisation of credit. ***Since nationalisation of commercial banks, priority sectors have been receiving bank credit at concessional interest rates which has adversely affected the profitability of banks.*** According to the Narasimham Committee, "easy and timely access to credit is far more important than its cost." Therefore, it recommended phasing out of concessional interest rates for priority sectors.

4. Increase in expenditure. Since the nationalisation of banks, it seems that no attempt has been made to keep expenditures within justifiable limits. ***Under the cover of societal concerns, many unremunerative branches have been set up in semi-urban and rural areas. These branches have operated primarily as deposit centres and never generated adequate credit business and, consequently, income. Moreover, while bank credit to agriculture and small industry has been provided at subsidised interest***

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rates, the unit cost of administering the loans has been high. Over the years there has also been rapid growth of staff and presently most of the bank branches are overstaffed, the employees' efficiency level is low and there is general lack of discipline and work culture. The salaries of bank employees are not related to productivity. There has also been weakening of supervision and control. All these factors have contributed to accelerated growth of expenditures and have thus eroded profitability of commercial banks considerably.

5. Lax regulation and supervision. ***The supervisory system to control the working of the commercial banks has always been lax though the degree of political interference has been very high.*** Laxity in regulation was partly on account of the absence of clarity on internationally comparable accounting norms. This in practice had resulted in lack of the essential elements of financial discipline. The banks themselves never attempted to set up their own control systems.

6. Lack of competition. Despite the number of banks being large, there has been little competition between them. ***The public sector banks which shared more than 90 per cent of the banking business among them had little incentive to compete. Competition was inhibited by the regulated interest rates. The activities of the Indian Banks Association further curtailed scope for competition.*** Non-price competition was also completely missing. Customers, under the circumstances found it difficult to shift from one bank to another. Lending to large borrowers being subject to consortium arrangements meant absence of any competition.

The above factors together led to creation of a banking system that was virtually bankrupt. According to Vijay Joshi and I.M.D. Little, it was "ill-suited to the task of allocating credit or performing ordinary banking functions efficiently."[5]

BANKING SECTOR REFORMS

Some recommendations were made by the Chakravarty Committee in 1985 for improving the performance of the banking sector. However, the government lacking initiative did not carry out reform measures earnestly. ***In 1991, the country was caught into a deep economic crisis. The government at this juncture decided to introduce comprehensive economic reforms. The banking sector reforms were part of this package.*** The government appointed a Committee on the Financial System under the chairmanship of M. Narasimham in August 1991 which delivered its report within three months. The government also appointed the Committee on Banking Sector Reforms under the Chairmanship of M. Narasimham which submitted its report in April 1998. These reports are landmark documents and have influenced greatly the banking sector reforms during the past few years.

Prudential Regulation and Supervision

The Narasimham Committee on the Financial System (1991) recommended the strengthening of banking supervision and drastically changing its character, away from intensive micro-intervention over credit decisions towards prudential regulation. These recommendations were accepted by the government. Hence, to this end, the RBI issued guidelines in April 1992 for income recognition, asset classification and provisioning, and adopted the Basel capital adequacy standards. These norms have already reached full force. Accrued income from non-performing loans can no longer be treated as income of the banks. Non-performing loans have been defined as credit facility in respect of which interest has not been received for 180 days. These loans are classified as substandard, doubtful and lost, depending on how long they have been non-performing. Provisioning has to be made at 10 per cent for substandard loans, 20-50 per cent for doubtful loans and 100 per cent for lost loans. As for capital adequacy, banks are expected to reach a 9 per cent capital to risk-weighted asset ratio (CRAR). The actual CRAR is now well above this stipulated minimum – it was 13.6 per cent as at end-March 2017.

The Board of Financial Supervision has been constituted as a supervisory authority. It is presently functioning within the RBI. India has yet to devise appropriate regulatory structures. It is now recognised that early warning systems are as much necessary as *ex post* monitoring. Earlier, the RBI's emphasis was on on-site inspection of banks. The off-site back-up was very much lacking in the past on account of out-of-date information system. It is now planned to streamline the information system so that off-site analysis can be made to support on-site monitoring.

Rehabilitation of Public Sector Banks and DRTs

By 1991 the banking system had become extremely fragile due to the large proportion of non-performing assets (NPAs). Overall NPAs were as large as 24.8 per cent of the total loan portfolio in 1994. However, there were significant variations among banks. Even in the cases of relatively stronger banks, the proportion of non-performing assets was around 8-10 per cent and this clearly reflected the malaise in the banking system. Further, half of the public sector banks made huge losses and the net profit to assets ratio varied between minus 6.8 per cent to plus 0.5 per cent.

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A clean up operation was thus urgently required in the mid-1990s. The government decided to follow the recapitalisation route for the restoration of net worth. ***The recapitalisation requires direct infusion of capital to the banks from the budget and the non-performing assets are left on their books.*** The government did not accept the recommendation of the Narasimham Committee on the Financial System for setting up the Asset Reconstruction Fund. The Narasimham Committee had favoured creation of such an institution so that banks could transfer their bad assets to it at a discount or at book value. The case for an Asset Reconstruction Fund is that transferring non-performing assets from the banks' books enables the bankers to work for the future while the task of recovery is delegated to the specialists. But the government felt that because of the large expanse of the country an Asset Reconstruction Fund was not ideally suited to carry out recovery programme. The banks were nonetheless provided legal support in their recovery efforts. For instance, the Debts Recovery Tribunals (DRTs) were set up under the Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993, to help banks and financial institutions recover their dues speedily without being subject to the lengthy procedures of usual civil courts. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act, 2002 went a step further by enabling banks and some financial institutions to enforce their security interest and recover dues even without approaching the DRTs. However, as noted by Raghuram G. Rajan, the amount banks recover from defaulted debt is both meagre and long delayed. For instance, "***the amount recovered from cases decided in 2013-14 under DRTs was ₹ 30,590 crore while the outstanding value of debt sought to be recovered was a huge ₹ 2,36,600 crore. Thus, recovery was only 13 per cent of the amount at stake. Worse, even though the law indicates that cases before the DRT should be disposed off in six months, only about a fourth of the cases pending at the beginning of the year are disposed off during the year – suggesting a four year wait even if the tribunals focus only on old cases.*** However, in 2013-14, the number of new cases filed during the year were about one-and-a-half times the cases disposed off during the year. Thus, backlogs and delays are growing, not coming down."[6] The poor debt recovery is due to the strong power and influence that the large borrowers command and their ability to delay the legal process considerably by hiring the finest legal brains to work for them in repeated appeals. The system renders the banker helpless *vis-a-vis* the large and influential promoter. While the large borrowers continue to refuse to repay their debts running into thousands of crores of rupees to the banks, on a personal front, they continue to lead a lavish lifestyle enjoying all luxuries of life. As remarked sarcastically by Rajan, in this country "we have many sick companies but no 'sick' promoters."[7] In this context, it may be pointed out that wilful defaults amounted to as much as ₹ 1.12 trillion in September 2017. In fact, wilful defaults in public sector banks alone amounted to as much as ₹ 93,500 crore in September 2017 (wilful defaulters are those who have the money but do not pay up).

Reduction in the SLR and the CRR

For a long time, the government intervention in India's banking sector was in the form of high SLR and CRR. In this manner, the government pre-empted bank resources at below market rates. This policy benefited the government as it reduced the cost of borrowing. But it was directly responsible for eroding the profits of the banks. The Narasimham Committee on the Financial System, therefore, recommended a reduction in the SLR to 25 per cent by 1996 and an unspecified reduction in the CRR. The government accepted these recommendations and acted decisively as regards reducing both the reserve ratios. By law the upper limit of SLR is 40 per cent. However, in 1970, the SLR was 25 per cent. In two decades, starting from this level, it had risen to 38.5 per cent in 1991. The government has now succeeded in reducing it drastically. ***SLR has now been reduced to 18.75 per cent of total net demand and time liabilities.***

The CRR is an instrument of monetary policy and thus has to be reduced with some caution. In India, until the government securities market develops sufficiently to enable open market operations to become the prime instrument of monetary policy, the CRR should not be reduced drastically. Hence, some price in terms of efficiency has to be paid for ensuring effective monetary control. These considerations notwithstanding, the CRR was reduced to 13 per cent by May 1996. It was further reduced in stages and brought down to 4.5 per cent on June 14, 2003. Thereafter, it was increased several times to check liquidity overhang in the system. It was raised to 9.0 per cent on August 30, 2008. During the second half of the financial year 2008-09, as conditions of slowdown in the economy appeared, CRR was reduced in stages to inject more liquidity into the system. It was reduced to 5.0 per cent effective January 17, 2009. However, in view of inflationary conditions in the economy, it was again raised in stages to 6.0 per cent on April 24, 2010. Thereafter, it was reduced in stages. ***CRR was brought down to 4.0 per cent with effect from February 9, 2013.***

Deregulation of Interest Rates

The administered interest rate system in India had over the years become unduly complex and had acquired features which reduced its ability to promote effective use

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of credit. This was not realised in the official circles until its deficiencies were highlighted by the Chakravarty Committee of the RBI.

On account of societal concerns, a system of concessional interest rates was developed in this country. The Chakravarty Committee was in favour of providing credit at concessional rates to target groups under the priority sector lending. However, even this committee observed that the system of concessional interest rates had become too complex and needed some kind of rationalisation. While the system of multiple concessional rates was initially adopted due to genuine social concerns, it acquired a number of distortions over the years. The political expediency often led the government to follow a populist policy whereby it made various categories of borrowers eligible for borrowings at concessional rates of interest. This preoccupation with concessional interest rates unfortunately, deflected attention from much more effective instrument of social justice which takes the form of adequate and timely availability of credit to neglected sectors, particularly in the backward rural areas.

The policy of providing too many bank loans to different favoured groups at multiple concessional interest rates not only contributed to the deterioration in the profitability of banks, but also led to inefficient use of credit reflected in uneconomic creation of additional capacity and its under-utilisation, heavy accumulation of inventories, and poor quality of project preparation and its inefficient implementation. The Chakravarty Committee had, therefore, favoured a very selective approach to the use of concessional interest rates. The Narasimham Committee argued that the system of directed credit programmes based on too many concessional interest rates had acquired too many distortions and thus it would be desirable to phase out concessional interest rates.

The system of non-concessional lending rates has lacked flexibility, because there has been too much regulation of these rates ignoring the changes in the market. The Chakravarty Committee had recommended that the controlled competition among banks should be allowed implying that banks should have some freedom to vary their lending rates of interest, subject to some minimum rate fixed by the RBI and not the maximum. This was considered to be necessary for better allocation of credit. The Narasimham Committee has forcefully argued that "interest rates should increasingly be allowed to perform their main function of allocating scarce loanable funds among alternative users. For them to do so, rates will have to be allowed broadly to be determined by market forces."

The government accepted this approach with respect to the role of interest rates in the Indian economy and adopted the necessary measures to deregulate them. However, prior to 1990-91, progress in this direction was very limited. In 2003, the system of Benchmark Prime Lending Rate (BPLR) was introduced. This was expected to serve as a benchmark rate for banks' pricing of their loan products so as to ensure that it truly reflected the actual cost. However, ***the BPLR system fell short of its original objective of bringing transparency to lending rates.*** This was mainly because under the BPLR system, banks could lend below the BPLR. The share of sub-BPLR lending (excluding export credit and small loans) of scheduled commercial banks was as high as 77 per cent in September 2008, before dropping to 70 per cent, which was still very high, during the quarter ended June 2010. As a result, it was difficult to assess the transmission of policy rates of the Reserve Bank to lending rates of banks.

In order to address these concerns, the Reserve Bank constituted a Working Group under the chairmanship of Deepak Mohanty to review the BPLR system and suggest changes to make credit pricing more transparent. The Working Group submitted its report on October 20, 2009. Based on the recommendations of the Group and the suggestions from various stakeholders, the Reserve Bank issued the Guidelines on the Base Rate system on April 9, 2010. Accordingly, ***the system of Base Rate came into effect from July 1, 2010.*** Base rate system was introduced in order to ensure that banks cannot lend below a certain benchmark. The base rate calculation takes into account (1) cost of funds (i.e., interest rates offered by banks on deposits); (2) operating expenses to run the bank; (3) minimum rate of return (*i.e.,* margin or profit); and (4) cost of maintaining CRR. This shows that banks do not consider 'repo rate' in their calculations. They primarily depend on the composition of CASA (Current Accounts and Savings Accounts) and deposits to calculate the lending rate. Under this system, most of the banks follow average cost of fund calculation. As a result, any cut or increase in repo rate by the RBI does not get transmitted to the bank customers immediately. For example, while over the period January 2015 to April 2016, the RBI reduced the repo rate by as much as 125 basis points, the banks lowered their base rate by only about 60 basis points. In other words, ***the monetary policy transmission under the base rate system remained weak.***

In order to improve the monetary policy transmission, the RBI has introduced the MCLR (marginal cost of fund-based lending rate) with effect from April 1, 2016. The banks are, therefore, effective April 1, 2016, required to set their lending rate based on MCLR. As per RBI's guidelines it is mandatory for the banks to consider the repo rate while calculating MCLR. The main components of MCLR

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calculation are: (1) operating expenses; (2) cost of maintaining CRR; (3) marginal cost of funds ((*i*) after considering interest rates offered on savings/current/term deposit accounts, (*ii*) based on cost of borrowings, i.e., short-term borrowing rate which is repo rate and also on long-term borrowing rates, and (*iii*) return on net worth); and (3) tenor premium (an additional slab of interest over the base rate, based on the loan tenure and commitments). The main difference between the two calculations are (*i*) marginal cost of funds, and (*ii*) tenor premium. The marginal cost of funds will have high weightage while calculating MCLR. Therefore, ***any change in key rates (increase or decrease) like repo rate will bring change in marginal cost of funds requiring an immediate change in the MCLR.*** MCLR is required to be reviewed monthly.

MCLR and monetary policy transmission. The RBI calls the effective passing of repo rate change into interest rate change by the banking system as an important part of monetary transmission. ***Monetary transmission in complete sense is the way in which a monetary policy signal (like a repo rate cut) is passed into the economy in producing the set objectives.*** To illustrate, consider the case of a repo rate reduction by the RBI. It is aimed to reduce overall interest rate in the economy and thus promoting loans for consumption and investment. This consumption and investment boost will be realized only if banks resort to cutting interest rates in response to the reduced repo rate. Previously, under the base rate system, banks used to change the base rate, only occasionally. They used to wait for long time or waited for large repo rate cuts to bring corresponding reduction in their base rate. Now with MCLR, banks will have to readjust interest rate monthly. This means that such quick revision will require incorporating changes in repo rate. In other words, ***MCLR will enable better monetary policy transmission.***

Phasing out of Directed Credit

After nationalisation of commercial banks, a strong case was made out in favour of directed credit on the grounds of both efficiency and equity. In practice, however, the directed credit not only undermined the profitability of the banks but also failed to promote efficiency and equity. Hans Binswanger and S.R. Khandker have shown that directed credit had only a mildly positive effect on output and a zero effect on employment in the agricultural sector.[8] The effects of directed credit on equity were also not encouraging. In the agricultural sector, medium and large farmers had pre-empted a large part of such credit and had thus received large subsidies.

The small-scale industries had received subsidised credit on 'market failure' grounds for more than three decades. This period should have been long enough to overcome market failures. Therefore, there was no justification to provide subsidised credit to this sector under the changed circumstances.

On account of the above reasons, the Narasimham Committee recommended a phasing out of the directed credit programme. However, some credit support was recommended in the medium term to the priority sector which was redefined. Further, the Committee suggested that the credit target for this sector should be reduced from 40 per cent to 10 per cent of the aggregate. The government, however, seems to be lacking political will to implement this recommendation. Over the years, large farmers, transporters and small industrialists have greatly benefited from directed credit programmes. These economic groups have powerful lobbies and would not allow the government easily to phase out directed credit programmes.

As far as deposit rates are concerned, only the savings banks deposits interest rate was regulated. With effect from October 25, 2011, RBI deregulated savings banks account interest rates, wherein banks will have to keep a uniform rate of interest for savings accounts with deposits up to ₹ 1 lakh, while differential interest rates could be set for savings bank deposits over ₹ 1 lakh.

Promoting Competition

Until 1991 there was little competition in the banking sector. The public sector banks dominating the banking industry in terms of size of assets, acted as a monolith. ***The government has now recognised the need to make banking industry more competitive. It has thus made certain policy changes such as deregulation of interest rates and dilution of consortium lending requirements. Moreover, banking has been opened up to the private sector.*** As a result, new private sector banks have been set up, old private sector banks have expanded their operations and more foreign sector banks have entered the Indian banking industry. This has promoted competition and has helped in increasing efficiency.

Prompt Corrective Action (PCA)

Public sector banks have incurred heavy losses during the last few years. Cumulatively, their losses before tax amounted to as high as ₹ 92,000 crore between the third quarter of financial year 2015-16 and third quarter of financial year 2017-18.[9] In fact, with losses during the last three years, 11 out of 21 PSBs have been placed under PCA framework by the RBI. ***While taking the decision on putting a bank under PCA, the RBI assesses its standing on three counts, namely capital adequacy ratio (CAR), net NPAs, and return on assets (RoA).*** Banks become PCA

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candidates when they fail the minimum requirements of CAR or net NPAs rise above 6 per cent or the RoA is negative for two years. Breach of any one condition is sufficient to trigger PCA. The banks under PCA regime face restrictions on expanding loan book, as the aim is to turn the bank around and improve financial and credit profiles.

Launching of Indradhanush Programme

The government rolled out a seven-point action programme named ***'Indradhanush'*** in August 2015 aimed at improving the performance of public sector banks (PSBs). The initiatives under this revamp plan cover aspects such as: (*i*) appointments with separation of the post of managing director and non-executive chairman in some large PSBs; (*ii*) proposal for a 'bank board bureau' (BBB); (*iii*) plan for capitalisation (it was estimated that the PSBs would need ₹ 1.8 trillion during the four year period ending 2018-19 of which ₹ 700 billion would be provided from budgetary allocations and ₹ 1.1 trillion would be raised by PSBs from the capital market); (*iv*) plan for de-stressing banks' books; (*v*) empowerment of PSBs by encouraging them to take the business decision independently – without interference from government; (*vi*) a new framework for accountability based on 'key performance indicators' (KPI); and (*vii*) better governance through continuous engagement with banks. As envisaged under these reforms, PSBs are expected to work as 'private' entities in terms of their business strategies, operations, controls and financial targets.

INDIAN BANKING: CONCERNS AND CHALLENGES FOR FUTURE

The decades of the 1980s and 1990s and the first decade of the present century witnessed several financial crises around the world. These crises were sometimes country specific, often regional, and in the case of the current ongoing crisis, global in scope. In each case, the banking sector became a drag on the real economy, jeopardised public finances and hurt economic growth. It is noteworthy that while other countries and regions went through banking upheavals, the Indian banking remained safe. This was both due to cautious and prudent regulation exercised by the Reserve Bank, on the one hand, and the relatively lower globalization of our banking sector on the other hand. However, in recent times, the performance of the banking sector in general, and public sector banks in particular, has raised many concerns. ***The NPAs are rising, profitability ratios are declining (in fact, many banks have been incurring huge losses), and bank frauds of immense magnitude are emerging which have shaken people's faith in the entire banking system.*** We consider below the concerns that need to be addressed and the challenges that need to be met in the Indian banking sector on an urgent basis.

1. Ensuring financial inclusion. Despite its impressive progress, commercial banking in India has not penetrated sufficiently to serve the large mass of rural, illiterate and poor people in a meaningful way. Rough estimates indicate that of the 60,000 habitation centres in the country, only about 30,000 centres are covered by the commercial banks. The Reserve Bank has taken several steps during the last few years to further financial inclusion. These include, opening new basic savings bank deposit accounts (BSBDAs) under Pradhan Mantri Jan Dhan Yojana (PMJDY), increasing the number of banking outlets, initiating and then expanding the Business Correspondent model and the use of mobile phones, for extending banking outreach, etc. The most important initiative in this regard is the decision to open 'payment banks' and 'small finance banks'. For details, please see Appendix to this chapter.

2. Improving credit flow to rural areas. One disquieting feature in the present business scenario of the Indian banking sector is the concentration of banking business in a few metropolitan areas. Six top metropolitan centres account for almost half of the total banking business of the Indian banking sector. More alarmingly, rural areas account for only a small proportion of credit. Further, the North-Eastern, Eastern and Central regions continue to display backwardness in the availability as well as utilisation of banking services. Thus, efforts need to be taken to improve credit flow to the rural areas as also to the North-Eastern, Eastern and Central regions.

3. Conforming to the priority sector lending target. A number of banks have failed to meet the target of credit set for priority sector as a whole and also for agricultural credit. Non-adherence to the agricultural lending target by a large number of banks raises concern as still a large proportion of India's population depends on the agricultural sector for livelihood.

4. Financing infrastructure. India is a supply constrained economy and the biggest supply constraint is infrastructure. It is widely recognised that poor and inadequate infrastructure is adding to production costs, adversely affecting the productivity of capital, and eroding the competitiveness of our productive sectors. Therefore, it is necessary to finance the huge infrastructure needs. However, as pointed out by Subbarao, ***a big issue in bank financing of infrastructure is the asset-liability mismatch.*** While infrastructure typically requires long-term financing, the deposits of banks, their main source of funds, are relatively short-term. This problem of asset-liability mismatch is not

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unique to India and exists in other countries also. However, while in advanced countries, the long-term finance space is filled by insurance companies and pension and provident funds, there is no such provision in India. Thus, the burden of infrastructure financing has to be borne by the banks. According to Subbarao, "Going forward, financing infrastructure is going to be a big challenge for the banking sector. This huge and growing demand for infrastructure finance will have to be met even as banks wrestle with expanding their traditional banking services. Apart from finding the resources, banks will also need to hone their skills in appraisal and management of risks inherent in infrastructure financing."[10]

5. Resolving the NPA Problem. The ratio of gross NPAs to gross advances for scheduled commercial banks has been rising consistently during recent times and this is a serious cause of worry. Banks do not earn any interest on their NPAs and, on top of that, they need to set aside money or provide for them. The gross NPAs to gross advances ratio which was 2.5 per cent as at end-March 2011 rose to 4.6 per cent as at end-March 2015 and further to as high as 9.3 per cent as at end-March 2017. Equally striking has been the concentration of these bad loans. More than 86 per cent of the NPAs are in the public sector banks (PSBs) where the NPA ratio reached 11.7 per cent as at end-March 2017. This is taking a heavy toll on the health of PSBs. According to *Economic Survey* 2016-17, at least 13 of those banks accounting for approximately 40 per cent of total loans are severely stressed, with over 20 per cent of their outstanding loans classified as restructured or NPAs.[11] With such a large fraction of their loans impaired, ***it has become extremely difficult for them to earn enough income on their assets to cover their running and deposit costs.*** Banks around the world typically strive for return on assets (RoA) of 1.5 per cent or above. But Indian public sector banks are much below this international norm. In fact, their RoA was only 0.4 per cent in March 2017 and September 2017. Many PSBs have continued to record negative profitability since March 2016.[12]

To tackle the problem of NPAs, RBI devised two schemes in the recent past.[13] One is the strategic debt restructuring (SDR) scheme which allowed the banks to convert their debt into equity according to a pre-determined formula, take control of the company and then induct new management to turn it around. However, the scheme did not succeed much. The second scheme was the Scheme for Sustainable Structuring of Stressed Assets (S4A), under which banks could offer existing managements an opportunity to rehabilitate the project by dividing the debt into two parts: a 'sustainable' component, which would be serviced by the project based on some assumption about revenues, and the 'excess' component which would be converted into equity or redeemable preference shares. This scheme required the sustainable debt to be more than 50 per cent. Two other proposals under discussion for tacking the problem of NPAs are: *(i)* selling assets to privately managed asset reconstruction companies (ARCs), which can then organise the turnaround; and *(ii)* creating a government-owned 'bad bank' which would purchase problem loans from the banks, and concentrate on turning the projects around, possibly with the help of ARCs. It has been suggested that bank managements are likely to be much more willing to sell assets at a discounted price to another public sector company, which could then undertake the task of negotiating the best deal with potential new owners.

6. Tackling the menace of bank frauds. The recently disclosed Punjab National Bank fraud involving the companies of Nirav Modi and Mehul Choksi amounting to more than ₹ 12,600 crore has severely shaken the confidence of the people in the banking system. This is on top of the information provided recently in a Reuters study of State-owned banks which says that ***there were as many as 8,670 cases of bank fraud over the last five financial years ending March 31, 2017 totalling as much as ₹ 61,260 crore.*** Though the Reuters study did not have details of the nature or method of loan frauds, an older, 2015 survey on fraud in Indian banking by Deloitte lists the main reasons for increase in fraud as follows: (1) lack of oversight by line manager or senior management of deviation from standard or existing processes; (2) business pressure to meet targets; (3) lack of tools to identify potential red flags; and (4) collusion between employees and external parties. And the annual Kroll Fraud and Risk Report goes on to add that junior employees were the second most common perpetrators of frauds, just behind joint venture partners.

To tackle this increasing menace of bank frauds, the RBI has formed an expert committee to look into this problem. However, this is not enough. As correctly pointed out by Shailesh Dobhal, "In a people-dominated sector like financial services where the critical business and customer-level information is increasingly accessible to even operational-level employees, such breach of trust by the very people who are supposed to be custodians of it can be lethal for the business." ***What is, therefore, required is a new culture of vigilance about employee fidelity.***[14]

7. Tackling the four 'Rs'. *Economic Survey* 2017-18 has stressed the need for four 'Rs' for tackling the problems of the banking sector. ***These four 'Rs' are: (i) recognition, (ii) resolution, (iii) recapitalisation, and (iv) reform.***[15]

(*i*) Recognition. There is progress on this front. The RBI's asset quality review has revealed that the gross NPA ratio of both public and private sector banks is higher than

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was earlier thought, but in public sector banks, it is alarming at about 12 per cent. However, according to Montek S. Ahluwalia, even this is an underestimate because it does not include assets that are 'stressed' but not yet NPAs. "The market assessment is that when these chickens come home to roost, the NPA percentage may increase by upto 6 per cent."[16]

***(ii)* Resolution of problem loans.** In this respect, the adoption of the Insolvency and Bankruptcy Code (IBC) 2016 is a major progress. Once an account is referred by a creditor under the IBC to the National Company Law Tribunal (NCLT), and is admitted, the powers of the management and the board are transferred to an independent insolvency professional (IP). The IP then looks for someone willing to take over the project on suitable terms, including a write down of the debt. If the IP succeeds in finding an investor willing to take over the project with a sufficient reduction of debt, and the creditors accept the debt reduction, then the new management takes over. If no one is willing to take over, or if the banks do not accept the debt reduction implied by the package, the company is simply liquidated. The law prescribes that the process must be completed within 180 days. According to *Economic Survey* 2017-18, over 525 cases of corporate insolvency have been admitted across all the NCLT benches. Voluntary Liquidation Proceedings and one Fast-Track Corporate Insolvency Resolution have also been initiated.[17]

(iii)* Recapitalisation.** The government announced a ₹ 2.11 lakh crore recapitalisation package for the public sector banks on October 24, 2017. Out of this, ₹ 1.35 lakh crore is to be provided through 'recapitalisation' bonds. Another ₹ 76,000 crore will come from budgetary support and banks tapping the market (while ₹ 18,000 crore will come from the government's recapitalisation plan under ***Indradhanush, banks will raise the remaining ₹ 58,000 crore from the market by diluting government equity). According to the government, this 'strengthening' of the PSBs via recapitalisation is necessary to finance economic activity and spur 'genuine' infrastructure lending for upcoming mega projects.

(iv)* Reforms.** On the reforms front, the government has asked public sector banks to inspect all accounts above ₹ 50 crore and has proposed a new law for fugitive economic offenders. However, these measures are not enough. Most of the observers agree that the Indian public sector banks suffer from excessive political interference and have weak governance structure. Decision makers are confused about their objectives as banks are subject to dual regulation by the government and the RBI. Some critics have suggested the merger of public sector banks. However, as correctly pointed out by Ahluwalia, merging strong banks with other banks will do nothing to improve the average balance sheet, and will saddle the merged entity with innumerable personnel problems related to establishing equivalence across different bank cadres. ***What we need are reforms that improve governance, upgrade the skill set and improve the quality of risk assessment with the public sector banks. As far as improving governance and upgrading the skill set is concerned, some economists have suggested the privatisation of PSBs. However, this may not prove to be a panacea as the private sector banks also face problems of similar nature. Some leading private sector banks have seen big jumps in the level of their bad loans in recent times. Worse, some of them have indulged in misreporting of NPAs and have grossly underreported bad loans. ***The problem facing the public sector banks and the private sector banks is similar and this relates to the poor performance of the corporate sector and its inability to judge the risks.*** Many companies have demonstrated that they have borrowed more than is prudent. Part of the problem has been the general inability to enforce contracts. Reports also appear off and on in the media that some private sector banks have been resorting to "evergreening" of loans, a process by which banks lend anew to companies already struggling to service existing loans.

As far as improving the quality of risk management is concerned, in the coming years, two big forces will define the environment in which Indian banks will be called upon to operate: (*i*) a rapidly globalising India, and (*ii*) a fiercely competitive industry. "This means in the main that Indian banks will have to upgrade their risk management architectures. In this regard, an important lesson thrown up by the crisis is that in addition to managing more effectively the traditional roles such as credit risk, operational risk and market risk, banks also need to manage some new risks that have proven to be significant such as reputation risk, counterparty credit risk, liquidity risk, interest rate risk in the banking book and incremental risk in the trading book." Risk management will require pushing the frontiers of knowledge and transforming that knowledge into practical policy.

8. Reviewing operations of foreign banks. According to *Report on Trend and Progress of Banking in India* 2010-11, it is necessary to address at this juncture the concerns raised by operations of foreign banks. It is a fact that these banks are mostly present in metropolitan areas, and as such their role in furthering financial inclusion is limited. It is also a fact that even after having a lower priority sector lending target, many of them have not been meeting this target. Moreover, the target set for export credit has also not been met by many of these banks. On the other side, their share in the sensitive sector credit, especially share in the real

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estate credit, has been particularly high. Accordingly, there is an urgent need for a review of the operations of foreign banks.[18]

APPENDIX TO CHAPTER 46: PAYMENT BANKS AND SMALL FINANCE BANKS

The Reserve Bank began issuing licences for the setting up of payments banks and small finance banks (SFBs) in 2016. So far, seven licences have been issued for payments banks out of which two banks – Airtel Payments Bank and India Post Payments Bank – commenced operations before March 31, 2017 and two others – Paytm and Fino – started operations by the quarter ending June 2017. As far as SFBs are concerned, 10 SFBs have been granted licences of which six had commenced operations before March 31, 2017. While the entry of these new types of banking institutions is expected to bring about far-reaching changes in the landscape of the Indian banking sector and increase the competition in the Indian banking industry, ***the primary objective of these differentiated banks is furthering financial inclusion.*** While both payment banks and small finance banks have some overlap in purpose – mostly in increasing access to banking facilities – there are some key differences. One such difference is that a payment bank has a limit of ₹ 1 lakh on deposit per account; small finance banks have no such limit. Payment banks cannot lend, while small finance banks can give loans.

Payment Banks

Payment banks have the primary objective of financial inclusion through providing small savings accounts and payment/remittance services to the migrant labour workforce, low income households, small businesses, other unorganised sector entities and other users, by enabling high volume-low value transactions in deposits and payment/remittance services in a secured technology-driven environment. Payment banks are not allowed to undertake lending activities and will be restricted to holding a maximum balance of ₹ 1 lakh per individual customer initially. Apart from amounts maintained as CRR with the Reserve Bank on outside demand and time liabilities, these banks will be required to invest minimum 75 per cent of their 'demand deposit balances' in government securities/treasury bills and in other securities with maturities upto one year that are recognised by the Reserve Bank as eligible securities for maintaining SLR and hold maximum 25 per cent in current and time/fixed deposits with other scheduled commercial banks for operational purposes and liquidity management.

Small Finance Banks

The objective of setting up of small finance banks (SFBs) is furthering financial inclusion by: (*i*) providing savings vehicles primarily to unserved and underserved sections of the population, and (*ii*) supplying credit to small business units, small and marginal farmers, micro and small industries, and other unorganised sector entities, through high technology-low cost operations. SFBs have a priority

Box 46.1

Payment Banks and Small Finance Banks

Payment Bank	Small Finance Bank
• Can accept deposits, but only upto ₹ 1 lakh per individual customer	• Allowed to take deposits of any amount
• Cannot lend in any form	• Can lend but focus will be on small lending
• Can open small savings accounts	• Can finance small business units, small and marginal farmers, micro and small industries, and unorganised sector entities
• Can provide remittance services	• Can provide remittances as well as credit cards
• Allowed to use automated teller machine (ATM) or debit cards	• Allowed to use ATM or debit cards
• Not allowed to issue credit cards	• Has to ensure that 50 per cent of loan portfolio constitutes advances of upto ₹ 25 lakh
• Can distribute products such as mutual funds, insurance and third-party loans	• Can distribute financial products such as mutual funds, insurance and pension

Source: Vivina Vishwanathan, "What to Expect from Small Finance Banks?", *Mint*, September 18, 2015, p. 16.

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sector lending target of 75 per cent of adjusted net bank credit (ANBC) and at least 50 per cent of the loan portfolio should comprise of loans and advances of upto ₹ 2.5 million. Of the 10 SFBs that have been given licences, six SFBs had started operations by end-March 2017. As at end-March 2017, there were 397 functioning offices of SFBs. As regards their funding profile, borrowings constituted about 60 per cent of their liabilities, while the share of deposits was only 18 per cent. Total loans provided by them as at end-March 2017 were ₹ 168 billion of which 93.4 per cent went to the priority sector with a focus on agriculture and micro, small and medium enterprises.[19]

Box 46.1 compares the features of payment banks and small finance banks.

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47 Chapter

THE RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) was established as a shareholders' bank on April 1, 1935. It retained this character for about fourteen years. Over this period important developments took place in India. The country got freedom on August 15, 1947, and the nationalist government decided to initiate the process of planned economic development. It was felt that a State-owned central bank was better suited to the requirements of the country. Hence, the RBI was nationalised on January 1, 1949. In this chapter, we shall discuss:

- Main functions of the Reserve Bank of India
- Monetary policy of the Reserve Bank of India
- Control of currency by the Reserve Bank of India
- The Reserve Money
- Control of credit by the Reserve Bank of India
- Short-term liquidity management.
- Banking Laws (Amendment) Act, 2012.

MAIN FUNCTIONS OF THE RESERVE BANK OF INDIA

The RBI, like any other central bank, performs almost all traditional central banking functions. But, due to the specific nature of the country's underdeveloped economy it has undertaken some developmental and promotional functions also. First we shall explain its general central banking functions.

General Central Banking Functions

Since the RBI was established on the model of the Bank of England, its general central banking functions are very much similar to those of the Bank of England. These functions are as follows:

1. Issue of currency notes. Like any other central bank ***the RBI has the sole right to issue currency notes.*** Under the original Act, there was provision for issuing currency notes according to the ***proportional reserve system.*** This system being relatively less elastic, was not suited to the requirements of development planning. Thus, the original Act was amended and the proportional reserve system of note issue was replaced by the minimum reserve system. According to the RBI (Amendment) Act, 1957 a minimum gold and foreign exchange reserve was to be of ₹ 200 crore. Value of gold was not to be at any time less than ₹ 115 crore. This provision released a large amount of foreign exchange which was earlier kept as part of the reserve. Following the policy of other central banks the RBI (Amendment) Act, 1957, empowered the RBI to dispense with the entire holding of foreign securities with the prior sanction of the Central government.

2. Banker to the government. ***The RBI renders useful service to the government in the capacity of its banker, agent and adviser.*** The RBI has the obligation to transact the banking business of the Central and State governments. Thus, it accepts money on account of these governments, makes payment on their behalf, and carries out other banking operations such as their exchange and remittances. It also undertakes the management of public debt and is responsible for the issue of new loans. For ensuring the success of the loan operations it actively operates in the gilt-edged market. The RBI has intimate knowledge of the financial markets and thus offers useful advice to the government on the quantum and terms of new loans. The RBI is authorised to make ways and means advances to the government. These short-term loans are repayable within 90 days from the date of advance. Since the discharge of this function involves receipts and payments on behalf of both Central and the State governments not only in the capital cities but also in many other towns, it has appointed the State Bank of India as its sole agent for transacting government business.

The need for co-ordination between the monetary and fiscal policies is now being universally recognised. As such, central bank's function as the adviser to the government has assumed new significance. Prior to the beginning of economic planning in India the RBI's role as the adviser to the government was rather limited. The position has, however, changed over the period of planning. The range of the advisory function of the RBI is now quite extensive. "Like all central banks, the Bank (the RBI) acts as adviser to the Government not only on policies concerning banking and financial matters but also on a wide range of

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economic issues including those in the field of planning and resource mobilisation. It has of course a special responsibility in respect of financial policies and measures concerning new loans, agricultural finances and legislation affecting banking and credit. The Bank's (RBI's) advice is sought on certain aspects of formulation of the country's Five Year Plans such as the financing pattern, mobilisation of resources and institutional arrangements with regard to banking and credit matters."[1]

3. Banker's bank. ***The RBI has been vested with extensive powers to control commercial banking system under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.*** According to the Banking Regulation Act, 1949, all banking companies included in the Second Schedule of the RBI are called scheduled banks. For inclusion in the Second Schedule a bank must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors. All scheduled banks are under a statutory obligation to maintain a certain minimum of cash reserve (to be decided by the RBI) with the RBI against their demand and time liabilities. An amendment of 1962 to the Banking Regulation Act has empowered the RBI to determine the Cash Reserve Ratio (CRR) between 3 per cent and 15 per cent of aggregate demand and time liabilities. Apart from this statutory control over the commercial banks, the RBI can also direct the scheduled banks to maintain 100 per cent cash reserve against all deposits received after a specified date. Further, the scheduled banks are required to submit weekly statements of their transactions to the RBI.

The RBI provides financial assistance to scheduled commercial banks and State co-operative banks in the form of discounting of eligible bills and loans and advances against approved securities. As it is the responsibility of the RBI to see that the banking system in the country grows on sound lines, it takes into consideration such factors as the financial position of the borrowing bank, its lending policy and the securities offered while making advances to it. The RBI has the power to deny rediscounting facility to any bank without assigning any reason for it.

The Banking Regulation Act, 1949, and the various amendments made therein define the RBI's regulatory functions relating to banks. These functions are quite extensive and cover such areas as the licensing of banks, branch expansion, liquidity of the assets of commercial banks, their management and methods of working, amalgamation, reconstruction and liquidation.

4. Exchange management and control. ***The RBI is required to stabilise the external value of rupee. For this purpose it functions as the custodian of the nation's foreign exchange reserves.*** It is obligatory for the RBI to buy and sell currencies of all the members of the IMF.

In 1947, the Foreign Exchange Regulation Act (FERA) was passed and with it foreign exchange management and control became a distinct function of the RBI. The Act empowered the RBI to exercise control over foreign securities, foreign payments and transfer of currency, bullion and securities to foreign nationals. This Act was later substituted by the Foreign Exchange Regulation Act, 1973, which came into force on January 1, 1974. FERA provided that no unauthorised person would buy or sell foreign exchange. Over the years, FERA was amended a number of times. ***Now, FERA has been replaced by Foreign Exchange Management Act (FEMA).***

5. Credit control. Credit control is generally considered to be the principal function of a central bank. De Kock has pertinently remarked: "It (credit control) is the function which embraces the most important questions of central banking policy and one through which practically all other functions are united and made to serve a common purpose."[2] In fact, it is this function which enables a central bank to realise both exchange stability and price stability. ***The RBI, like any other central bank, now possesses power to use almost all quantitative and qualitative methods of credit control.***

6. Agricultural finance. Although the RBI has been established on the model of the Bank of England, yet it has a unique feature in its character. This pertains to its role in providing agricultural finance. For enabling the RBI to fulfil this role, the RBI Act laid down for setting up of a special Agricultural Credit Department. ***With the setting up of the National Bank for Agricultural and Rural Development (NABARD) on July 12, 1982 the major functions of the Agricultural Credit Department of the RBI were taken over by the former.***

7. Collection and publication of data. The RBI has been entrusted with the task of collection and compilation of statistical information relating to banking and other financial sectors of the economy. Out of various publications of the RBI, two are relatively more important. *The RBI Bulletin* is a monthly publication. It presents not only statistical and other information in summary form, but also provides results of important studies and investigations conducted by the RBI. *The Report on Currency and Finance* is an annual publication. It provides a comprehensive review of various developments of economic and financial importance.

Developmental and Promotional Functions

The First Five Year Plan began in 1951 and with it an era of planned economic development ushered in the country. ***With the increase in importance of economic development at the national level, new demands were made on the RBI***

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and its functions increased steadily. Now the RBI performs many developmental and promotional functions as would be clear from the discussion below:

1. Mobilisation of savings and extending banking to unbanked areas. The RBI's functions are not confined merely to the exercise of restrictive controls over the money market. It attempts to mobilise savings through banks and other financial institutions for productive purposes. In exercise of its licensing power, RBI has been putting pressure on commercial banks to open their branches in semi-urban and rural areas. This has reduced the dependence of the people in these areas on indigenous bankers and moneylenders. In order to adjust their activities according to the requirements of the customers, particularly at small places, the commercial banks have also done several innovations in banking practices.

2. Providing security to depositors. A major obstacle to banking development in India was frequent bank failures. In fact, this was a major hindrance in mobilising deposits. Therefore, the RBI with the objective of providing security to depositors took initiative to establish the Deposit Insurance Corporation of India in 1962. In order to mobilise savings the RBI played an active role in the establishment of the Unit Trust of India (UTI) in 1964. To small investors the UTI offered in the past the advantages of reduced risk, steady income, liquidity and expert management.

3. Development of agricultural credit institutions. Development of the institutional agricultural credit has been a major function of the RBI from its very inception. In fact, this has been the RBI's statutory obligation ever since it was established. However, during the 1960s and 1970s it took particular interest in developing agricultural credit. It not only assisted the development of short-term co-operative credit for agriculture but also participated in the establishment of the Agricultural Refinance and Development Corporation (ARDC) in 1963. The National Bank for Agriculture and Rural Development (NABARD) was set up on July 12, 1982. Half of its share capital has been provided by the RBI. The NABARD has taken over the entire undertaking of ARDC.

4. Helping the development of specialised institutions of industrial finance. Though development of institutional industrial finance has not been a statutory obligation of the RBI, in the context of planned economic development it assumed great importance. Obviously of all factors necessary for development, capital is of crucial importance. Normally commercial banks avoid giving long-term credit. For meeting this financial requirement of the industry, a country must have specialised institutions of industrial finance. Until India got Independence, there was no such institution in the country. Thus, at the initiative of the Central government, the RBI actively participated in establishing various specialised institutions of industrial finance, including the Industrial Finance Corporation of India and the State Financial Corporations. The Industrial Development Bank of India was set up as a subsidiary of the RBI. However, later on it was made an autonomous institution.

5. Advisor to the government. We have earlier pointed out that the RBI, besides being a controller of credit, is also an advisor to the government. The significance of the RBI's advisory function has considerably increased in the context of government's attempts to accelerate the development process in the country. The Central government asks for its advice not only on financial matters, but also on general economic problems. As such, it plays a useful role in the development process of the country.

MONETARY POLICY OF THE RESERVE BANK OF INDIA

The monetary policy refers to a regulatory policy whereby the central bank maintains its control over the supply of money for the realisation of general economic goals. This concept of monetary policy may be right in the context of developed economies, but in less developed countries like India, monetary policy cannot remain confined only to controlling the supply of money. In other words, monetary policy, if it does not play any positive role, will serve only a limited purpose. Viewing the Reserve Bank's monetary policy in this framework we find that it has been designed to meet the particular requirements of India's developing economy. Aptly summarising the RBI's monetary policy, S.L.N. Simha has stated, "The Reserve Bank's responsibility is not merely one of credit restriction. In a growing economy there has to be a continuous expansion of money supply and bank credit and the central bank has the duty to see that legitimate credit requirements are met. The Bank's responsibility in the circumstances is mainly to moderate the expansion of credit and money supply, in such a way as to ensure the legitimate requirements of industry and trade and curb the use of credit for unproductive and speculative purposes. That is why the Bank has rightly called its credit policy in recent years as one of controlled expansion."[3]

The Chakravarty Committee had emphasised that price stability, growth, equity and social justice, promoting and nurturing new monetary and financial institutions are important objectives of monetary policy in India. The difficulty in formulating and implementing monetary policies arises from the trade offs among various objectives which need to be evaluated on a continuous basis. This cannot be

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done independently by the RBI. The RBI's monetary policy has to subserve the national economic and social objectives as enunciated from time to time in the Five Year Plans. This puts an unusual constraint on the monetary policy options of the RBI. The inflationary pressures in India have often warranted a check on growth of money supply, but the need to prevent the adverse effects of restricting the flow of bank credit on economic growth has dissuaded the RBI from taking action on a scale warranted to achieve the desired stability in prices. Thus in a country like India the thrust of monetary policy cannot be restricted to regulation of money supply alone. Nonetheless, it has to be admitted that the price stability and economic growth should be the two basic objectives of the economic policy in India and regulation of money supply is necessary to achieve these objectives.

Y. Venugopal Reddy has however remarked, ***"In India, monetary policy has always emphasised the objectives of price stability and growth. What this, in effect has meant in practical policy setting is formulating a balance between the two objectives depending on the evolving situation but in the broad context of keeping the inflation rate within a reasonable bound."***[4] Critics have sometimes argued that commitment to price stability is not demonstrable in the absence of inflation targeting. However, according to Reddy, "The position of the RBI has been that the commitment to price stability in India must be derived from three sources — policy statements, policy actions and, above all, the policy outcomes."[5]

In order to ensure RBI's complete control over the supply of money and credit, it has been given exclusive power to issue currency notes. For judging how far the RBI has succeeded in achieving this objective, one has to know the relative importance of various types of money in circulation in the country. In certain countries, the legal tender money (coins and paper money) is the predominant medium of exchange. In other countries, the place of legal tender money is relatively secondary and most payments are made through cheques. Whereas the former type of monetary system is to be found in France, the latter is to be found in England and the United States. The nature of the monetary system in India due to predominance of legal tender money thus resembles the French monetary system rather than the British or the American.

The Urjit Patel Committee Report submitted in January 2014 advocated the adoption of a policy of inflation targeting. Such targeting "tasks monetary policy to achieve price stability as an unambiguous and sustainable goal which the private sector can anchor its expectations about future inflation".[6] In accordance with the recommendations of the Committee, the Reserve Bank of India and the Government of India signed an agreement on February 20, 2015. ***This agreement has put in place a monetary policy framework which makes flexible inflation targeting the official goal of the central bank.*** The Reserve Bank of India (RBI) Act, 1934 was amended in May 2016 to provide a statutory basis for the implementation of the flexible inflation targeting framework (for details on inflation targeting, please see the section 'Inflation Targeting: Urjit Patel Committee Report' of Chapter 44).

The Monetary Policy Process. Section 45ZB of the amended RBI Act, 1934 provides for an empowered six-member Monetary Policy Committee (MPC) to be constituted by the Central Government by notification in the Official Gazette. Accordingly, ***the Central Government in September 2016 constituted the MPC.*** The MPC determines the policy interest rate required to achieve the inflation target. The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations. The Financial Markets Committee (FMC) meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy (weighted average lending rate) is kept close to the policy repo rate.

Before the constitution of the MPC, a Technical Advisory Committee (TAC) on monetary policy with experts from monetary economics, central banking, financial markets and public finance advised the Reserve Bank on the stance of monetary policy. However, its role was only advisory in nature. With the formation of MPC, the TAC on monetary policy ceased to exist.

Money Supply in India. In India, presently both currency notes and cheques are used for payment purposes — coins constitute a very small part of money supply in the country and they are now used for making small payments. As on March 31, 2018, the total money supply (M_1) in the country was ₹ 32,67,331 crore. M_1 is money supply in the narrow sense. It includes (*i*) currency with the public, (*ii*) demand deposits with banks, and (*iii*) other deposits with the Reserve Bank of India. The last one is a very small component of M_1 and is thus not considered in any monetary analysis. As on March 31, 2018, the amount of currency with the public was ₹ 17,59,712 crore and demand deposits had amounted to ₹ 14,83,712 crore. The currency with the public and the demand deposits with the banks thus accounted for 53.8 per cent and 45.4 per cent of the money supply (M_1) respectively. Other deposits with the RBI were only 0.8 per cent of M_1. Nowadays a broader concept of money supply, that is M_3 is used. M_3 includes M_1 and time deposits with banks. As on March 31, 2018, the amount of M_3 was

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₹ 1,30,62,587 crore of which time deposits with the banks were ₹ 1,06,95,255 crore.

In monetary economics, ***control of money supply usually refers to control of the supply of currency and deposit money.***

CONTROL OF CURRENCY BY THE RESERVE BANK OF INDIA

By control of currency, we generally mean the control over the supply of currency notes and coins. As mentioned earlier, coins constitute a very small part of money supply in the country and special measures are not needed to regulate its quantity. Regulation of the quantity of currency notes is, however, very important and the RBI enjoys monopoly power to issue them. There is a separate Issue Department in the RBI for issuing currency notes. The RBI can issue any amount of notes on the basis of reserves maintained in the form of gold bullion, foreign securities, rupee coins, rupee securities and Treasury bills. The only condition that has to be satisfied is that at no time the gold and foreign exchange reserves should fall below ₹ 200 crore, of which gold reserve must always be of ₹ 115 crore. This system of note issue inherently suffers from inflationary tendency.

The mechanics of note issue is rather simple. When the RBI wants to issue currency notes, it generally transfers either foreign securities or rupee securities or both from the Banking Department to the Issue Department. It has to be mentioned in this context that the amount of note issue will be equal to the amount of securities received by the Issue Department from the Banking Department. The RBI is empowered to issue notes also on the basis of reserves maintained in the form of Treasury bills. When the RBI pursues contractionary policy, it reverses the above process. The securities are transferred from the Issue Department to the Banking Department, and the currency notes of an equal amount are withdrawn from circulation. The success of the RBI in regulating the supply of currency has been doubted by many. It is argued that the rampant inflation over the years is a distinct indication of its failure in this regard. Some other economists contest this view and hold the government responsible for the inflation. In their opinion, as the RBI is completely subservient to the government, it could not pursue an independent policy when the government recklessly indulged in deficit financing under various Plans.

In the USA, the central bank (the Federal Reserve System) is an autonomous institution and is thus the sole monetary authority. The situation is, however, different in India. The RBI which is the central bank in this country is not a completely autonomous monetary institution. It is under a statutory obligation to lend any amount of money that the Central government decides to borrow from it. Though the State governments are not empowered to borrow from the RBI, they nonetheless draw unauthorised overdraft from the RBI with impunity. The role of the RBI as the monetary authority has thus been undermined by the government. In practice, there are two monetary authorities in this country. These are the Central government and the RBI. Between these two, the Central government is more powerful.

THE RESERVE MONEY (RM)

In order to understand the role of the various monetary institutions and the government in determining the supply of money, it is necessary to understand the concept of the reserve money and the money multiplier process.

The Reserve Money and Money Multiplier

The reserve money is often referred to in monetary economics as high powered money, basic money, primary money or monetary base. The ability of the banking system to create deposit money depends on the amount of reserve money available and the portion of it which public holds in the form of currency. In India, the reserve money represents those liabilities of the RBI and the government which are considered to be eligible as reserves to be held by banks for the purpose of deposit money creation. Generally, currency liabilities of the RBI and the Central Government are considered eligible for being held as bank reserves to support deposit money creation. While the currency liabilities of the RBI consist of currency notes (excluding one rupee notes) the currency liabilities of the Central government consist of rupee coins and notes and small coins. Coins are not the liabilities of the RBI. The RBI performs only the task of issuing them on behalf of the government. Currency liabilities of the RBI and the government are thus the sum total of currency with the public, banks' reserves consisting of cash with banks and bankers' deposits with the RBI and 'other' deposits with the RBI. 'Other' deposits with the RBI are liabilities of the RBI to the non-bank sector and are thus in their character equivalent to currency with the public. They are very much relevant to deposit money creation. Hence, in India, ***the components of the reserve money are: (i) currency in circulation, (ii) bankers' deposits with the RBI and (iii) other deposits with the RBI.*** In India, currency in circulation is the biggest component of the reserve money. The share of currency in circulation was 63.0 per cent in the total reserve money on March 31, 1991. It rose to 75.6 per cent on March 31, 2018. Bankers' deposits with the RBI is the other important component of

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the reserve money. Its share in the reserve money was 36.2 per cent on March 31, 1991. It, however, declined to 23.4 per cent on March 31, 2018. 'Other' deposits with the RBI is a relatively smaller component of the reserve money. It accounted for 1.0 per cent of the reserve money on March 31, 2018.

Having discussed the concept of the reserve money, its various components and the rates at which it has grown since April 1991, it would be pertinent to explain the roles of various monetary institutions in its creation. In India, currency consists of currency notes and coins. Currency notes constitute the bulk of the currency in circulation and are being issued by the RBI. In contrast, coins and one rupee notes which are being issued by the Central government constitute a very small portion of the amount of currency in circulation. This fact leaves the impression that the RBI is the major monetary authority in this country. This, however, is not correct. In the formal sense, the RBI is the currency notes issuing authority. But since it is under a statutory obligation to buy all the Treasury bills which are being offered to it by the Central government, the latter has become the real monetary authority in the country. The bankers' deposits with the RBI are not made voluntarily by the banks. Their amount depends on the statutorily determined cash reserve ratio and the amount of demand and time liabilities of the banks. Hence, banks' role in creating reserve money is rather passive. They, however, remain a major monetary institution by virtue of being the creator of deposit money. The ability of the banking system to create deposit money depends on the amount of reserve money and portion of it which the public holds in the form of currency. Thus, bank reserves have a residual character. Another factor which determines the ability of the banking system to create deposit money is deposit multiplier, which depends on the currency-deposit ratio and the required reserve-deposit ratio.

The currency-deposit ratio in India was 1.35 at end-March 1956 (deposits in this computation represent aggregate deposits which are defined as demand deposits plus time deposits). Since then it has steadily declined to 0.13 in 2017-18. This steep fall signified the growth of bank deposits resulting from the rapid growth of banking facilities. Money multiplier (defined as $M_3 \div M_0$ where M_3 is broad money and M_0 is reserve money) rose from 1.60 at end-March 1956 to 6.3 at end-March 2017 and stood at 5.8 at end-March 2018.

CONTROL OF CREDIT BY THE RESERVE BANK OF INDIA

In India, the legal framework of the RBI's control over the credit structure has been provided under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The RBI has been empowered to use almost all the traditional instruments of credit control under the former; the latter has given it additional powers to use some other direct methods of credit regulation. If we consider the combined legal provisions under the two Acts we find that the RBI's powers to control the banking system are fairly comprehensive. Like any other central bank, the RBI resorts to bank rate manipulations, open market operations, reserve requirement changes, direct action, rationing of credit and moral suasion. Apart from employing these traditional methods of credit control, it directly influences commercial banks' lending policy, rates of interest, form of securities against loans and portfolio distribution.

However, ***the RBI's control over the supply of credit is rather weak in spite of the wide powers enjoyed by it.*** The main reason for this appalling state of affairs is the underdeveloped character of the Indian money market. As pointed out earlier, the traditional sector which includes indigenous bankers and moneylenders as the constituents, is completely out of its control. Whatever limited success the RBI has achieved in the past is mainly on account of its control over the modern sector of the money market. In the following pages, we shall consider the effectiveness of various techniques of credit regulation in India.

The Bank Rate Policy

Bank rate is the re-discounting rate that RBI extends to banks against securities such as bills of exchange, commercial papers and any other approved securities. The effectiveness of the bank rate policy depends mainly on three factors: (*i*) that the commercial banks in the country should not be averse to availing rediscounting facility from the central bank; (*ii*) that banks do not maintain any excess cash reserve against deposits and thus if extraordinary demands are made by the depositors, they have no option except that they rediscount bills from the central bank; and (*iii*) that banks must hold adequate quantity of such credit instruments which will be rediscounted by the central bank as per the legislation. Last two conditions are not satisfied in India. In the first place, the commercial banks in India are not much dependent on the RBI for financial assistance. Secondly, in the absence of a well organised bill market they lack adequate quantity of eligible bills which can be rediscounted from the RBI. Proper organisation of the various components of the money market is a prerequisite for the success of the RBI's bank rate policy.

The bank rate was 10 per cent during the 1980s. It was raised to 11 per cent effective from July 4, 1991 and further to 12 per cent effective from October 8, 1991. This was believed to be necessary to counteract the inflationary

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pressure. However, under the conditions that prevailed in India, the bank rate changes were not a very efficient method to regulate the supply of credit and money. This limitation of the bank rate was often underlined by the experts in this area. Making his observations on the effects of the RBI's bank rate changes on the Indian money market and the amount of credit, B. Rama Rao, a former Governor of the RBI, had stated, ***"The increase in the bank rate was intended to be a warning signal, for apart from its psychological effect, I doubt if under Indian conditions a slight increase of the rate can have any appreciable influence on inflationary situation."***[7]

Bank rate is currently 6.0 per cent. As a policy rate, it is now defunct and the RBI now focuses only on one policy rate — repo rate.

Open Market Operations

The technique of open market operations as an instrument of credit control was developed much later. In fact, the need for open market operations was felt only when the bank rate policy turned out to be a rather weak instrument of monetary control. Some monetary economists and bankers assert that bank rate policy and open market operations are complementary measures in the realm of monetary management. In India whereas bank rate changes were found to be rather ineffective due to the underdeveloped nature of the money market, importance of open market operations has always been recognised. ***As the government securities market is fairly well developed in the country, the environment for open market operations is quite favourable. At present the RBI Act authorises the RBI to conduct purchase and sale operations in the government securities, treasury bills and other approved securities.*** The RBI is also empowered to buy and sell short-term commercial bills. In India, since government securities are predominantly held by institutional investors, notably banks and insurance companies, dealings of the RBI in regard to open market operations are mostly confined to them.

Theoretically, the technique of open market operations is superior to bank rate policy. For the success of open market operations, the central bank has not to depend on the co-operation of commercial banks as it happens in the case of bank rate policy. Retaining initiative in its own hands, it can influence the reserve position of the commercial banks and thereby their capacity to advance credit. Open market operations are also considered superior to both CRR and SLR because they can be used as and when need arises whereas CRR and SLR are only altered in RBI's bi-monthly policy review. They are also long-term in nature since the securities sold or bought have maturities which are more than a year while a small hike in either the CRR or the SLR would have only short-term effects. Moreover, while CRR and SLR are dependent on consumers as they are calculated with respect to the net demand and time liabilities (NDTL) (that includes savings accounts, fixed deposits, etc.), open market operations do not have such constraints. On account of reasons such as these, Federal Reserve of New York has observed that "Open market operations are by far the most powerful and flexible tool of monetary policy".

The Cash Reserve Ratio

The cash reserve ratio (CRR) is a portion of the banks' NDTL (net demand and time liabilities) or deposits that they are required to maintain with the Reserve Bank in their specified current accounts. This money earns no interest. CRR, which is maintained on a fortnightly basis, is a tool that the central bank uses to manage money supply and liquidity in the market. A high CRR means banks have less to lend, which curbs liquidity; a low CRR does the opposite. Under the RBI (Amendment) Act 1962, ***the RBI is empowered to determine CRR for the commercial banks in the range of 3 to 15 per cent for the aggregate demand and time liabilities.*** This technique of credit control was used quite often during the 1970s and 1980s for controlling inflation. In the late 1980s, there was rapid growth of liquidity and thus the CRR was raised from 10 per cent to 15 per cent. For four years, the CRR remained unchanged at 15 per cent (this meant that for every ₹ 100 deposit that a bank held, ₹ 15 had to be kept aside with RBI).

The Narasimham Committee which submitted its report in November 1991 did not favour use of CRR to combat inflationary pressures. In its opinion, a high CRR adversely affected bank profitability and thus pressured banks all the time to charge high interest rates on their commercial sector advances. The CRR was thus brought down from a peak of 15 per cent in 1994-95 to 8.0 per cent in 2000-01. In October 2001, it was reduced to 5.5 per cent. CRR was reduced to 4.5 per cent effective from June 14, 2003. All these reductions of CRR freed cash balances and the lendable resources of the commercial banks. However, in a bid to control inflationary tendencies in the economy, the CRR was subsequently raised in stages. The final increase was made in August 2008, when CRR was raised to 9.0 per cent. Thereafter, it was again reduced in stages. ***The final reduction was carried out on February 9, 2013 when CRR was brought down to 4.0 per cent.***

The Statutory Liquidity Ratio

Apart from keeping a portion of deposits with the RBI as cash, banks are also required to maintain a minimum percentage of their deposits with them at the end of every business day, in the form of gold, cash, government bonds, or other approved securities. This minimum percentage is

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called the statutory liquidity ratio (SLR). In monetary jargon, SLR is the percentage of net demand and time liabilities (NDTL); in other words, bank deposits, that must be used to buy specified assets. ***The current SLR ratio is 18.75 per cent which means that for every ₹ 100 deposited in a bank, it has to invest ₹ 18.75 in any of the asset classes approved by RBI.***

CRR vs. SLR. While CRR is maintained in cash with RBI, SLR is maintained in liquid form with banks themselves in the form of gold or approved government securities. The purpose of maintaining SLR with banks themselves is to ensure that they can meet any unexpected demand from depositors at short notice by selling the bonds. Another difference between CRR and SLR is that while banks earn interest on their SLR deposits, they do not earn any returns from the money parked in the form of CRR. However, both CRR and SLR are reserves. A higher reserve requirement through either of them reduces the resources available with a bank to lend.

The Banking Regulation (Amendment) Act 1962, provided for maintaining a minimum SLR of 25 per cent by the banks against their NDTL (net demand and time liabilities). The Amendment Act also empowered the RBI to raise the SLR upto 40 per cent if it is considered necessary to control liquidity. The RBI used this power to raise SLR quite often during the 1970s and 1980s. Effective from September 22, 1990, SLR was made as high as 38.5 per cent of the commercial banks' net demand and time liabilities. The SLR remained at this level upto March 31, 1992. There were two reasons why the RBI had raised the SLR for banks. First, it reduced commercial banks' ability to create credit and thus eased inflationary pressures. Secondly, it made larger resources available to the State.

The Narasimham Committee did not favour maintenance of a high SLR. In its opinion, the SLR had become an instrument in the hands of the government to mobilise resources in support of the Central and State budgets. Keeping in view the recommendations of the Narasimham Committee, the government decided to reduce SLR in stages from 38.5 per cent to 25 per cent. The SLR was lowered down to 25 per cent effective from October 10, 1997. Thereafter, it was again reduced in stages and ***presently stands at 18.75 per cent.***

Selective Credit Control

Selective credit controls are generally meant to regulate credit for specific purposes. In a developing economy where frequent use of quantitative techniques of credit control may jeopardise development efforts, selective credit controls can be safely introduced to check misuse of borrowing facilities. ***The RBI, like many other central banks in various countries, has been empowered to use selective credit controls to regulate credit to specific branches of economic activities.*** Thus, it can prevent speculative hoarding of essential commodities and check undue rise in the prices. However, prior to May 1956, the RBI never introduced selective credit controls, though the speculative hoarding of foodgrains and essential raw materials causing steep rise in their prices warranted them.

The RBI relied mainly on three techniques of selective credit controls, *viz.*, the determination of margin requirements for loans against certain securities; determination of maximum amount of advances or other financial accommodation; and charging of discriminatory interest rates on certain types of advances. Apart from these measures the RBI may give directions to banks in general or even some particular bank as to the purpose for which loans may or may not be given. While introducing selective credit controls the government takes special precaution that the credit for production, movement of commodities and exports is not denied as it may have serious repercussions on the performance of the economy. The main thrust of selective controls is against speculative hoarding of essential commodities by traders.

For over 40 years, the RBI had extensively relied on the technique of margin requirements to check the hoarding of essential commodities for it causes artificial scarcities in the market and tends to raise prices. Since 1973-74 for more than two decades, stricter selective controls were imposed. The Credit Authorisation Scheme introduced in 1965 was also a kind of selective credit control. Under the scheme, the RBI regulated not only the quantum but also the terms on which credit flowed to the different large borrowers. The Credit Authorisation Scheme was finally withdrawn as part of financial sector reforms.

In 1996-97 the selective credit controls were liberalised on bank advances against a large number of price sensitive commodities. They have now been dispensed with.

SHORT-TERM LIQUIDITY MANAGEMENT

As stated earlier, the two basic objectives of Reserve Bank's monetary policy have been price stability and growth. The emphasis between these twin objectives has varied over time depending upon the evolving price-output situation. Initially, this was guided by the concept of developmental central banking crystallised in the First Five Year Plan, which required the Reserve Bank to create an institutional framework for industrial as well as rural credit to support economic growth. This reflected a widespread consensus that public investment could spur rapid growth. However, deficit financing which was undertaken on a massive scale

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to push up public investment caused intense inflationary pressures. In fact, inflation in 1970s trended up to around 9 per cent. Against this background, the Chakravarty Committee (1985) emphasised that price stability should be the 'dominant' objective of monetary policy with a concomitant commitment to fiscal discipline. The case for price stability as the dominant – if not sole objective of monetary policy gathered momentum in the early years of financial liberalisation. Although it had to stabilise the economy in the face of the balance of payments crisis of 1991, the Reserve Bank emphasised that its ultimate mission was to steer monetary policy, with its sights firmly set on inflation control. In its *Annual Report* 1992-93 (published in 1993), Reserve Bank noted that price stability is critical to sustain the process of reforms.

The period of 1990s and afterward has seen massive financial liberalisation all over the world and this has induced far-reaching changes in monetary policy. ***With increasing trends of deregulation of financial markets and globalisation the process of monetary policy formulation has acquired a much greater market orientation than ever before, inducing a shift from direct to indirect instruments of monetary control.*** This has been accompanied by several institutional changes in the monetary-fiscal interface to ensure that central banks possess the autonomy to anchor inflation expectations. The increasing trade and financial openness has further complicated the problems of monetary management. This is due to the reason that opening up of capital account exposes the economy to sudden switches in capital flows. These, in turn, can cause large changes in exchange rates over short periods of time. Volatility in capital flows and exchange rate impacts not only domestic demand and inflation, but also has implication for the maintenance of financial stability. ***"Central banks are thus concerned not only about price stability but also financial stability. With exogenous shocks hitting the economy at different points of time, the stabilisation of the real economy as well as financial markets requires a multi-pronged response from central banks. In a way, central banks have, therefore, emerged as the primary shock absorbers in the system".***[8]

Starting 1991, the Government of India has undertaken massive programmes of liberalisation in the industrial sector, external sector, and the financial sector. The Indian economy has been increasingly integrated with the global economy. The government also gave up the pegged exchange rate system and since 1993, the market exchange rate regime has been in vogue. Under this regime, the day-to-day movements in exchange rate are largely market-determined. In this scenario of opening of Indian economy and its increasing global integration, a re-orientation of monetary policy was required. It had not only to ensure price stability but also financial stability. "The growing integration of financial markets, while necessary for economic efficiency, posed challenges for monetary management in terms of heightened risks of contagion. Episodes of financial volatility, often sparked off by sudden switches in capital flows in response to various shocks — such as the East Asian financial crisis, sanctions after the nuclear explosions, downgrading of credit ratings, the meltdown of the information technology bubble and the September 11 US terrorist attacks required a swift monetary policy response. The Reserve Bank, therefore, began to emphasise the need to ensure orderly conditions in the financial markets as a prime concern of monetary management. ***Financial stability is now being recognised as a key consideration in the conduct of monetary policy, in terms of ensuring uninterrupted financial transactions; maintenance of a level of confidence in the financial system amongst all the participants and stakeholders; and absence of excess volatility that unduly and adversely affects real economic activity".***[9] In fact, monetary policy in India now simultaneously pursues the objectives of ***price stability, provision of appropriate credit for growth and increasingly, financial stability.***

The above discussion shows that the liberalisation of the Indian economy required a comprehensive recast of the operating procedures of monetary policy. In consonance with the increasing market orientation of the economy, the Reserve Bank had to shift from direct to indirect instruments of monetary policy. This required development of an array of monetary policy instruments, which would effectively modulate monetary conditions. The Reserve Bank is now able to influence short-term interest rates by modulating the liquidity in the system through repo operations under the Liquidity Adjustment Facility (LAF), reinforced by interest rate signals. Thus ***short-term liquidity management via repo operations and LAF has become an important operating procedure of monetary policy.*** LAF has also emerged as the key instrument of managing capital inflows that India has experienced since 2001-02 through sterilisation. This has helped in reducing the episodes of volatility in foreign exchange markets. ***In April 2004, the Market Stabilisation Scheme (MSS) was introduced to provide the Reserve Bank with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilisation operations.***

Reserve Bank now carries out short-term liquidity management through open market operations (OMOs) in the form of outright purchases/sales of government securities and repo and reverse repo operations under LAF. The OMOs are supplemented by changes in the repo rate. LAF has

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emerged as the principal operating instrument to modulate short-term liquidity. Since April 2004, MSS has also been used as an instrument of liquidity management. ***The latest instrument introduced by RBI is Marginal Standing Facility (MSF).***

Repos and Reverse Repos

Repo rate is the rate at which RBI lends to banks (i.e., the price at which it injects liquidity into the system). The higher the repo rate, more costly are the funds for banks and hence, higher will be the rate that banks pass on to customers. A higher rate signals that access to money is expensive for banks; lesser credit will flow into the system thus helping to bring down the liquidity in the economy. On the other hand, ***reverse repo rate is the rate at which RBI sucks out money from banks (i.e., the price at which it absorbs liquidity from the system).*** A higher reverse repo rate would give incentive to the banks to park money with the Reserve Bank, reducing liquidity and demand.

To control the strong inflationary pressures in the economy, RBI has relied basically on repo rate and reverse repo rate in recent times. This would be clear from the fact that over the period March 2010 to October 25, 2011, these rates were raised as many as 13 times. On October 25, 2011 repo rate was fixed at 8.50 per cent and reverse repo rate at 7.50 per cent. In its Monetary Policy for the year 2011-12 announced by the Reserve Bank on May 3, 2011, it was decided to shift towards a single policy rate regime — the repo rate. Thus, ***repo rate is now the single independently varying rate.*** The reverse repo rate was pegged at 100 basis points (bps) below the repo rate. Repo rate was fixed at 7.5 per cent and reverse repo rate at 6.5 per cent in March 2015. In its 'First Bi-Monthly Monetary Policy Statement, 2016-17' released on April 5, 2016, RBI pegged the reverse repo rate at 50 basis points (bps) below the repo rate. In this Policy Statement, repo rate was fixed at 6.5 per cent. Accordingly, the reverse repo rate was fixed at 6.0 per cent. The repo rate was fixed at 6.25 per cent in October 2016. Consequently, reverse repo rate was fixed at 5.75 per cent. In its First Bi-Monthly Monetary Policy Statement 2017-18 released on April 6, 2017, RBI pegged the reverse repo rate at 25 basis points below the repo rate. ***Repo rate is presently 5.75 per cent. Consequently, reverse repo rate is now 5.50 per cent.***

Liquidity Adjustment Facility (LAF)

The difference between the repo and reverse repo rates is the liquidity corridor or the liquidity adjustment facility (LAF). LAF was introduced by RBI in June 2000. ***The LAF operates through reverse repo auctions (i.e., the sale of government securities from the RBI portfolio for absorption of liquidity) and repo auctions (i.e., buying of government securities for injection of liquidity) on a daily basis, thereby creating a corridor for the call money rates and other short-term interest rates.*** All scheduled banks and primary dealers (PDs) are eligible to participate in the repo and reverse repo auctions. The maturity of repos is from one day to fourteen days. The funds under LAF are expected to be used by banks to meet their day-to-day mismatches in liquidity. ***The LAF has emerged as the principal operating instrument of monetary policy enabling the Reserve Bank to modulate short-term liquidity under varied financial market conditions.*** The LAF has enabled the Reserve Bank to de-emphasise targeting of bank reserves and focus increasingly on interest rates. This has also helped reducing the CRR (Cash Reserve Ratio) without engendering liquidity pressure.

Role and Importance of LAF. According to Reserve Bank of India, LAF plays an important role in market stabilisation as is clear from the following discussion:[10]

1. The LAF stabilises regular liquidity cycles, by allowing banks to tune their liquidity requirements to the averaging requirements over the reporting fortnight and smoothening liquidity positions between beginning-of-the-month drawdown of salary accounts to fund household spending and end-of-the month post-sales bulge in business current accounts.

2. The LAF irons out seasonal fluctuations. It injects liquidity during quarterly advance tax outflows or at end-March, when banks avoid lending on call, which adds to their Capital to Risk-weighted Assets Ratio (CRAR) requirements. It mops up liquidity in April to counter the typically large ways and means advances drawn by the government prior to the inception of its borrowing programme.

3. LAF modulates sudden liquidity shocks, by injecting liquidity on account of, say, temporary mismatches arising out of timing differences between outflows on account of government auctions and inflows on account of redemptions.

4. The LAF serves as an effective instrument for maintaining orderly conditions in the financial markets in the face of sudden capital outflows to ward off the possibility of speculative attacks in the foreign exchange market.

5. By funding the government through private placements and mopping up the liquidity by aggressive reverse repo operations at attractive rates, the LAF helps to minimise the impact of market volatility on the cost of public debt.

6. The LAF bore much of the burden of sterilisation in the face of sustained capital flows, especially since November 2000, by mopping up bank liquidity through reverse repos and, at the same time, gradually reducing reverse repo rates to enable a softening of the interest rate

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structure (the burden of sterilisation has been taken over by MSS since April 2004 as discussed below).

7. The Reserve Bank tailors monetary policy action through both quantum and rate channels of transmission. The LAF accords the Reserve Bank the operational flexibility to alter the liquidity in the system (by rejecting bids) as well as adjusting the structure of interest rates (through fixed rate operations) in response to evolving market circumstances.

Capital Inflows and MSS

Since the initiation of economic reforms in 1991, the country has witnessed large-scale capital inflows. While these capital inflows eased the external financing constraint, they also posed dilemmas for the conduct of the monetary policy. Under the circumstances, the objectives of containing exchange rate volatility and the maintenance of orderly conditions in the foreign exchange markets become difficult to achieve. As correctly pointed out by *Report on Currency and Finance,* "More particularly, if capital inflows outstrip the demand for foreign exchange, the appreciation of the domestic currency often necessitates interventions by the central bank to drain off the excess supply of foreign currency. In doing so, the accretion to foreign exchange reserves implies an immediate expansion in primary money with attendant consequences for maintaining price stability".[11]

Apart from the LAF, which is essentially an instrument of day-to-day liquidity management, Market Stabilisation Scheme (MSS) was introduced in April 2004 to provide the Reserve Bank with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilisation operations. ***The MSS is an arrangement between the Government of India and the Reserve Bank to mop up the excess liquidity generated on account of the accretion to the foreign exchange assets of the Bank to neutralise the monetary impact of capital flows.*** Under the scheme, the Reserve Bank issues treasury bills/dated Government securities by way of auctions and the cost of sterilisation is borne by the government. The sale of government securities helps in absorbing liquidity and in maintaining stability in the foreign exchange market.

Marginal Standing Facility (MSF)

Marginal Standing Facility (MSF) is a relatively new instrument. It was first announced by RBI in its credit policy released in the first week of May 2011. The objective of the MSF is to 'contain volatility in the overnight inter-bank rates'. Under this facility, all scheduled commercial banks can borrow overnight from RBI up to 1 per cent of their net demand and time liabilities. The interest rate is fixed at 25 basis points (bps) above the repo rate. With MSF, RBI has created a 50 bps corridor in policy rates with repo rate in the middle and MSF at 25 bps above the repo rate and reverse repo rate at 25 bps lower than the repo rate. ***Since repo rate is presently 5.75 per cent, MSF is fixed at 6.0 per cent.***

Under MSF, banks can request for a minimum of ₹ 1 crore and thereafter in multiples of ₹ 1 crore. In order to avail funds from MSF facilities, banks have to fulfil the margin requirement of 5 per cent in case they are borrowing against the Government of India dated securities and 10 per cent in case they wish to borrow against State development loans. Therefore, to make a request for, say ₹ 100, banks have to furnish ₹ 105 worth of Government of India bonds or ₹ 110 worth of State development funds.

As stated earlier, repo rate is now the single policy rate. Thus, every time the repo rate is increased, the reverse repo rate and MSF rate increase automatically. The liquidity corridor thus remains constant. By making repo the single policy rate, RBI has ensured that banks focus on deposit mobilisation to improve liquidity, and give better returns to customers.

BANKING LAWS (AMENDMENTS) ACT, 2012

The Banking Laws (Amendment) Bill, 2012 was approved by both the Houses of Parliament in December 2012. It received Presidential assent and was notified as the Banking Laws (Amendment) Act 2012 in January 2013. This Act paves the way for issuing new banking licences by giving the RBI greater regulatory power over the banking sector before it issues new licences to various private players. It is expected that opening of new private banks will increase competition in the banking sector and this, in turn, will be beneficial to banking customers by giving them more choice at competitive prices.

With this background, the amendments introduced by the Act can be categorised under two broad heads: (*i*) those intended to attract private sector investment and build investor confidence in the banking sector, and (*ii*) those intended to strengthen the RBI's regulatory powers over banks.

Reforms to Attract Investment

1. Banks may now issue more preference shares. The Act allows banks to issue preference shares in accordance with guidelines issued by the RBI. The permission given to private sector banks to issue preference shares provides banks with an additional avenue to raise finance without ceding any voting control to the holders of those instruments.

2. Increase in the ceiling on voting rights. Earlier, any shareholder of a private bank was, regardless of the

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extent of its shareholding, entitled to exercise only 10 per cent of the total voting rights of all shareholders of the company on a poll. The Act enables the RBI to increase, in a phased manner, the voting rights of shareholders of private sector banks from the current limit of 10 per cent to 26 per cent. Similarly, in the case of public sector banks, the voting right that may be exercised by a shareholder has been increased from 1 per cent to 10 per cent. The increase in voting rights would bridge the gap between the legal and economic ownership of banks and would enable the investors to exercise more control over the working of the banks. This could make banks more attractive to investors thereby facilitating raising of additional capital by the banks.

3. Increase in the authorised capital of nationalised banks. In order to enable nationalised banks to attract investors, the authorised share capital of nationalised banks has been increased to ₹ 30 billion from ₹ 15 billion. Nationalised banks have also been permitted to increase or decrease their authorised capital with the permission of the RBI and the Central government, and raise capital through rights issues and the issue of bonus shares. The ability to issue bonus shares is likely to be appreciated by the investors since, earlier, even nationalised banks with significant amounts of free reserves could not issue any bonus shares in the absence of an enabling legislation.

Regulatory Powers of RBI

1. Acquisition of substantial shareholdings. Before the enactment of the Act, prior acknowledgement of the RBI was required in all cases of acquisition or transfer of shares of a private sector bank that would increase the aggregate shareholding of an individual or group in the bank to 5 per cent, 10 per cent, or 30 per cent or more of the paid-up capital of the bank. The Act provides that approval of the RBI must be procured for any direct or indirect acquisition of shares or voting rights in an Indian bank which is in excess of 5 per cent of the paid-up capital of the bank.

Acquisition in excess of 25 per cent of the shares or voting rights of a bank would trigger the Takeover Code, and the acquirer would then have to make an open offer.

2. Power to seek information. The RBI can direct a banking company to provide information relating to the business or affairs of any Associate Enterprise of such banking company.

3. Right to supersede the board of directors. A significant power conferred on the RBI by the Act is the right to supersede the board of directors of a banking company if the RBI believes, in consultation with the Central government, that it is necessary to do so in the public interest or for preventing the affairs of any banking company from being conducted in a manner detrimental to the interest of the depositors of any banking company, or for securing the proper management of any banking company.

Miscellaneous

In addition to the above, the Act has some other provisions like (*i*) establishment of 'Depositor Education and Awareness Fund', (*ii*) amending the Indian Stamp Act 1899 to encourage foreign banks to operate through wholly owned subsidiaries instead of branches (for example, by exempting from stamp duty the conversion of a branch into a wholly owned subsidiary), (*iii*) amending the Contract Act to clear ambiguities relating to bank guarantees, etc.

As is clear from the above discussion, the amendments introduced by the Act seek to encourage private investment in the banking sector without compromising on the interest of the depositors and the public.

The Issue of New Bank Licences

The issue that has attracted the maximum attention is the decision to grant new bank licences. Some observers have argued that this is likely to open up the doors for large industrial conglomerates (including family controlled large industrial houses) and NBFCs (non-banking financial companies) to enter the banking business. As far as NBFCs are concerned, they specialise in just one or two segments. Therefore, to grow beyond a point, they need multiple products in their portfolio which is possible only if they are able to enter the banking sector. However, the entry of large industrial houses into the banking sector is fraught with dangers. In its 'Financial System Stability Assessment Update' released on January 16, 2013, IMF had warned India against licensing corporate entities to step into the business of commercial banking, saying that the risks associated with such a move potentially outweigh the benefits of creating more banks.[12] The objection to corporate ownership of banks is based on the very idea of efficient financial intermediation. A bank is a financial intermediary that raises money from depositors to lend to borrowers. In a country such as India, households are a major source of deposits while companies are large borrowers. ***A bank should ideally be a neutral intermediary, with no interest in the game other than intermediation.*** In other words, it should neither own a business group nor be owned by one. Else, it has strong incentives to abandon its unbiased position as an intermediary. As noted by Ajay Shah, "There are serious areas of concern with family controlled banks. The managerial team will have 'high-powered incentives' that come with high shareholding. Their super-incentivized staff will be energetic in dodging regulations; our financial regulatory agencies will not be able to rein them in."[13] In a similar vein, Nobel laureate economist Joseph Stiglitz, while

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delivering the 15th C.D. Deshmukh Memorial Lecture on January 3, 2013, said that "One of the real problems in the financial sector is that there are issues of conflict of interest. And, when you have corporates opening their own banks, you are opening up a venue for corporate conflict of interest". He added further, "If you want to take your own money, that is one thing. If you take depositors' money, you become a part of public responsibility."[14]

RBI had invited applications for new bank licences by July 1, 2013. A total of 26 applications were received which included some industrial groups like the Birlas, Anil Ambani group, Larsen & Toubro and Bajaj group etc. A high-level Committee was set up by RBI under former governor Bimal Jalan to screen these applications. ***On the basis of the decision arrived at by the Committee, RBI announced its decision on April 2, 2014 to issue licences to two applicants — IDFC (Infrastructure Development and Finance Corporation) and Bandhan.*** The former was a diversified financial services firm with a special focus on infrastructure financing, while the latter was the country's largest micro lender based in Kolkata. In August 2016, India opened its doors to banking licences as Reserve Bank allowed entities meeting its criteria to apply for a bank licence at any time, citing an argument that this would "increase the level of competition and bring new ideas into the system". Minimum capital requirement has been kept at ₹ 5 billion and it is stipulated that individuals seeking to lead an application for a new bank should be Indian residents. Large industrial groups may own up to 10 per cent of a new bank but may not launch an application in their own right – a move seemingly aimed at preventing banks from becoming 'captive' entities. The Reserve Bank said it welcomed applications from non-banking financial companies that were controlled by residents and had a record of at least 10 years. This is a nod to existing non-bank financial companies seeking to follow the example of the latest two entities to receive bank licences – Bandhan and IDFC.

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48 Chapter

CAPITAL MARKET IN INDIA

Every business unit needs money to finance its activities. The money is invested in physical resources, *i.e.*, land and building, machines and equipment, stock of raw materials, etc., which are used by the enterprise in production. All these resources together constitute 'capital'. ***Capital is often defined as "wealth used in the production of further wealth." In simple words, it comprises the money and the money value invested in a business unit.*** In this chapter, we shall discuss:

- The meaning and structure of the capital market
- Role of capital market in India's industrial growth
- Growth of capital market in India
- Factors contributing to the growth of capital market in India
- Problems of capital market in the pre-reform phase
- Steps undertaken in the post-reform phase to strengthen the capital market in India
- Steps undertaken by SEBI to promote healthy capital market development.
- Challenges requiring attention
- Appendix to Chapter 48: Measures to develop corporate bond market

CAPITAL MARKET

A business enterprise can raise capital from various sources. Long-term funds can be raised either through issue of securities or by borrowing from certain institutions. Short-term funds can also be borrowed from various agencies. Thus business units can raise capital from issue of securities and borrowings (long-term and short-term). In addition to business units, public corporations and governments (the Central government, the State and local governments), are the other major borrowers of funds. The lenders of funds include the individual investors (the household sector), the institutional investors, banks, and special industrial financing institutions. The borrowers and lenders are brought together through the financial markets. ***The term 'financial market' collectively refers to all those organisations and institutions which lend funds to business enterprises and public authorities.*** It is composed of two constituents:

(*i*) The Money Market,

(*ii*) The Capital Market.

While the money market deals with the provision of short-term credit, the capital market deals in the lending and borrowing of medium-term and long-term credit. We have already discussed the Indian Money market in the chapter 'Indian Money Market'.

In the present chapter, we propose to discuss the Indian capital market. However, before we do so, it is important to point out that both the money market and the capital market are interdependent. The reasons for their interdependence are as follows: (1) Most of the suppliers prefer to operate in both the markets. Within the framework of their investment policies, they look for the best opportunities wherever they may exist. (2) Users of the funds also have the option to obtain funds from either market. Exercising this choice, businessmen generally borrow in the market which offers them easy terms. (3) Funds freely flow between the two markets in a variety of ways. (4) The short-term and long-term rates of interest are interdependent. It is generally the short-term interest rates that change first and this brings about a change in long-term interest rate as well. (5) Some institutions serve both money and capital markets. For example, commercial banks constituting the core of the money market provide intermediate loans also. Similarly, dealers in short-term government securities buy and sell long-term bonds also.

STRUCTURE OF THE CAPITAL MARKET

Broadly speaking, the capital market can be divided into two constituents: (1) ***the financial institutions,*** and (2) ***the securities market.*** The financial institutions, *e.g.*, IFCI, IDBI, Exim Bank, SIDBI, IDFC, SFCs, LIC etc. provide long-term and medium-term loan facilities. These institutions are discussed in detail in Chapter 49. The securities market is divided into: (*i*) the gilt-edged market and (*ii*) the corporate securities market.

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Gilt-Edged Market

The gilt-edged market is the market in government securities or the securities guaranteed (as to both principal and interest) by the government. Since the government cannot default on its payment obligations, the government securities are risk free and hence are known as ***gilt-edged*** (which means 'of the best quality'). Important features of the government securities market are as follows:

1. It is a risk free market and returns are guaranteed. Accordingly, there is no uncertainty regarding yield, payment on time, etc. and there is no scope for speculation and manipulation of the market.

2. The government securities market consists of two parts — the new issues market and the secondary market. Since it is the Reserve Bank of India that manages entirely the public debt operations of the Central as well as the State governments, it is responsible for all the new issues of government loans. The secondary market deals in old issues of government loans and operates largely through a few large stockbrokers who keep in touch with the Reserve Bank and other prospective buyers and sellers. Reserve Bank, on its part, keeps on ready sale securities of various maturities to meet the market demand for them.

3. Reserve Bank of India plays a dominant role in the government securities market. As noted by S.B. Gupta, "there are only brokers or investors in the market and no dealers or jobbers (other than the RBI) who would make a market in government loans by standing ready to buy and sell any amount of government securities on their own account."[1] This special feature of India's gilt-edged market distinguishes it from the gilt-edged markets of many countries (like UK, USA etc.) where the central bank of the country is not the sole dealer in government securities.

4. The investors in the gilt-edged market are predominantly institutions which are required statutorily to invest a certain portion of their funds in government securities. These institutions include commercial banks, the LIC, the GIC and the provident funds. They mobilise the savings of the people through their various schemes and invest a certain proportion in government securities. They constitute what is called the *captive market* for government securities.

5. Government securities are the most liquid debt instruments.

6. The transactions in the government securities market are very large and each transaction may run into several crores of rupees.

7. For several years, the government securities market in India has been an 'over the counter market' (and not an auction market). However, since June 1992 (barring a few issues) government securities have been mostly issued through a system of first price sealed bid auctions. In this system of auction, "when auctioning a single unit, the highest bidder is awarded the item at the bid price. The auction of multiple units is called *discriminatory auction*, which involves awarding of stock to the highest bidders at the prices and quantities quoted in their bids until the supply is exhausted." The government's preference to auction system to other mechanisms for selling securities emanates from the ability of auctions to reveal more information about price determination and improve the allocation process.

On account of the risk-free returns guaranteed by the government securities market and its high liquidity, many private sector mutual funds have entered this market in a considerable way in recent times and have floated various gilt-edged funds for this purpose. Many individual investors (particularly those belonging to fixed-income groups) who are averse to risk taking have welcomed this opportunity as investment in gilt-edged funds is better than investment in bank fixed deposits due to better liquidity.

Corporate Securities Market

Corporate securities market is a market where securities issued by corporate firms (i.e., shares, bonds and debentures) can be bought and sold freely. It consists of the new issues market (the primary market) and the stock exchange (the secondary market).

The New Issues Market. The new issues market is also known the primary market. ***The new issues market is that part of the capital market which is concerned with the issue of new securities, i.e., bonds, debentures, shares, and so on.*** The public limited companies often raise funds through the primary market for setting up or expanding their business. However, to sell securities is not an easy task as the company has to fulfil various requirements and decide upon the appropriate timing and method of issue. It is quite normal to obtain the assistance of underwriters, merchant banks or special agencies to look after these aspects. The various methods through which capital can be raised are:

1. By prospectus. Capital can be raised from the general public by the issue of prospectus. The prospectus is an invitation to the general public for subscribing to the capital. The prospectus must contain various details regarding particulars of the company, its financial position, etc.

2. By offer for sale. This method is almost similar to the prospectus method except with a difference that initially shares are taken up by a third party in bulk. Later, a statement like prospectus is issued for sale of shares to the public. The peculiar feature of this arrangement is that company has already received the money and any premium

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received from the public goes to this third party rather than to the company.

3. By private placing. Under this arrangement, the shares are sold to individuals or institutions directly by making a private appeal to them. This results in substantial saving as the cost of raising capital in this method is less than the cost of raising capital via other methods.

4. By offering rights issue. Companies may also raise capital from the existing shareholders by making a rights issue. Under a rights issue, the shareholders have the right to a certain number of shares in proportion to the shares held by them.

The Stock Exchange. ***The stock exchange (or the secondary market) is a highly organised market for the purchase and sale of second-hand quoted or listed securities*** 'Quoting' or 'listing' of a particular security implies incorporating that security in the register of the stock exchange so that it can be bought and sold there. The Securities Contracts (Regulation) Act, 1956 defines a stock exchange as "an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

ROLE OF CAPITAL MARKET IN INDIA'S INDUSTRIAL GROWTH

1. Mobilisation of savings and acceleration of capital formation. In developing countries like India plagued by paucity of resources and increasing demand for investments by industrial organisations and governments, the importance of the capital market is self-evident. In this market, various types of securities help mobilise savings from various sections of the population. The twin features of reasonable return and liquidity in the stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

2. Promotion of industrial growth. The capital market is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels rather than in the unproductive sectors like real estate, bullion etc. Thus, it stimulates industrial growth and economic development of the country by mobilising funds for investment in the corporate securities.

3. Raising long-term capital. The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this clash of interests by offering an opportunity to investors to buy or sell their securities while permanent capital with the company remains unaffected.

4. Ready and continuous market. The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. The element of easy marketability makes investment in securities more liquid as compared to other assets.

5. Proper channelisation of funds. An efficient capital market not only creates liquidity through its pricing mechanism but also functions to allocate resources to the most efficient industries. The prevailing market price of a security and relative yield are the guiding factors for the people to channelise their funds in a particular company. This ensures effective utilisation of funds in the public interest.

6. Provision of a variety of services. The financial institutions functioning in the capital market provide a variety of services, the more important ones being the following: (*i*) grant of long-term and medium-term loans to entrepreneurs to enable them to establish, expand or modernise business units; (*ii*) provision of underwriting facilities; (*iii*) participation in equity capital; and (*iv*) expert advice on management of investment in industrial securities.

GROWTH OF CAPITAL MARKET IN INDIA

Government Securities Market

Since 1991, the investor base for government securities has expanded rapidly. Besides banks and insurance corporations, finance companies, corporates and financial institutions have also begun to invest in government securities. The maturity structure of debt has significantly shifted in favour of medium-term and short-term borrowings.

As far as secondary market is concerned, a deep, wide and vibrant gilt-edged market has emerged as a result of a series of structural and institutional reforms. The secondary market turnover of government securities registered spectacular increase since mid-1990s. This is due to a substantial rally in the government securities market.

Over the years, the turnover in the Government securities market and yield have generally witnessed an inverse relationship. During the period of rising yields, the turnover tended to be subdued, while during the period of softening in the yields, the turnover increased sharply.

Corporate Securities Market

Consequent upon the policy of liberalisation adopted by the government in July 1991 and the subsequent abolition of Capital Issues Control with effect from May 29, 1992,

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the corporate securities market got a tremendous boost as the following discussion clearly brings out.

Primary Market or the New Issues Market

New Capital Issues by Private Sector. The number of new capital issues by private sector was only 364 in 1990-91 and the amount raised by them was ₹ 4,312 crore. The number of new issues rose to 1,678 in 1994-95 and the amount raised by them to ₹ 26,417 crore. However, resource mobilisation by private sector companies declined consecutively for three years during 1995-96 to 1997-98 at an average annual rate of 48.1 per cent. The resource mobilisation during 1997-98 was only of the order of ₹ 3,138 crore though it picked up somewhat to ₹ 5,013 crore in 1998-99 and further to ₹ 5,692 crore in 2001-2002. Resource mobilisation by private sector through capital issues stood at ₹ 26,716 crore in 2015-16 and it rose substantially to ₹ 59,905 crore in 2016-17.

New equity issues, including qualified institutional placement (QIP), increased significantly during 2017-18, spurred by the buoyancy in the secondary market. Initial public offers (IPOs) and right issues increased more than three times to ₹ 1,052 billion from ₹ 325 billion in the previous year. Companies mobilised a total of ₹ 838 billion through 200 IPO issues. Insurance companies accounted for 52 per cent of the total resources raised through IPOs in 2017-18.

Capital issues consist of two parts — shares and debentures. Prior to 1992-93, debentures were a more popular means of raising long-term funds and provided almost 70 per cent or more resources raised through new capital issues. Shares accounted for a mere 12 per cent of the resources raised through new capital issues in 2001-02 while as much as 88 per cent of resources were raised through debentures. Thereafter, the position changed significantly. In 2004-05, 87.6 per cent and during the years 2005-06 to 2010-11, almost the entire resources were raised through shares. In 2014-15, 54.6 per cent resources were raised through shares and 45.4 per cent through debentures. In 2015-16 and 2016-17 once again, almost entire resources were raised through shares.

The persons who hold shares are known as shareholders or members and are part owners of the company. So, they enjoy certain rights like voting power, receipt of profits in the form of dividends etc. ***A company can issue two types of shares, namely equity shares and preference shares.*** The preference shares carry fixed rate of dividend and enjoy preference in respect of payment of dividend and repayment of capital in the event of the company being wound up. Unlike preference shares, equity shareholders are not guaranteed any dividend because it depends upon the yearly profits. Therefore, equity shareholders face maximum risk in the company. However, equity shares have a chance of earning more than preference shares in years of prosperity. In fact, equity shares have now become a much favoured form of investment in our country as would be clear from the fact that ***almost the entire amount raised through shares in recent years has been through the floating of equity shares*** (excepting the year 2007-08 when 8.6 per cent of the amount raised through shares was via preference shares).

As against shareholders, debenture holders do not have any share in the ownership of a company. Debentures are merely loans which carry fixed rate of interest and must be paid annually. Debentures can either be convertible or non-convertible. Convertible debentures are those debentures which can be converted into equity capital at fixed date or after a specified period. Non-convertible debentures do not carry any such rights. These days partly convertible debentures have become quite popular. These debentures have two parts — one convertible into equity shares at a fixed time and the other non-convertible. New instruments introduced in recent years are non-convertible debentures (NCDs) with detachable equity warrants, zero interest fully convertible debentures (FCDs), secured zero interest partly convertible debentures (PCDs) with detachable and separately tradeable warrants, fully convertible debentures with interest (optional), zero interest secured redeemable multi-option convertible debentures, etc.

Debt Market. ***The Indian debt market is composed of government bonds and corporate bonds.*** Bonds issued by the Central government, *i.e.,* the Government of India are the predominant and most liquid component of the bond market. Government bonds are usually much less volatile than equities and far more liquid than equities. As far as corporate bond market is concerned, it has picked up considerably in recent years as bond issues have become easier in regulatory terms. The RBI has increased the exposure ceiling limit for single and group borrowers, and also for counterparties, quite significantly. Bonds are also efficient investments when it comes to raising debt for long-gestation projects. Resources mobilised through the corporate bond market stood at ₹ 4,91,884 crore in 2015-16 and this rose further to ₹ 6,70,275 crore in 2016-17[2] (also see Appendix to this chapter).

Mutual Funds

A mutual fund is a special type of investment institution. It pools the savings of people (particularly small investors) and invests them in a widely diversified portfolio. Mutual funds issue securities (known as units) to the investors (known as unit-holders). These units are issued in accordance

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with the money invested by the unit-holders. The profits and losses are shared by the investors in proportion of their investments. In accordance with the risk-appetite of the investors and to meet their varied diversified needs, the mutual funds offer a large variety of schemes. These schemes can be broadly divided into open-ended and close-ended schemes. In the case of a close-ended scheme, the subscription period remains open only for a specific period. At the end of this period, the entire corpus is disinvested and the proceeds are distributed amongst the unit-holders. In the case of an open-ended scheme, an investor can buy or sell the units on a daily basis. The scheme, itself, has a perpetual existence and thus, the corpus is ever-changing. The units of a mutual fund are listed on a stock exchange for dealing in the secondary markets. The funds available are invested by the trustees of the mutual fund for the benefit of unit-holders. These trustees and/or the AMC (asset management company) have experts on financial matters who have vast experience in managing financial resources and in dealing in capital markets. Thus, while a small retail investor has limited experience and limited resources to benefit from the capital market, he can hope for better return by investing in a mutual fund which not only has better managerial expertise but also a large pool of resources which can be invested to build up a diversified investment portfolio.

The first step in the field of mutual funds industry in India was taken in 1963 when the Unit Trust of India (UTI) was set up at the initiative of the Government of India and the Reserve Bank. The industry was opened to public sector entities such as government-owned banks, life insurance companies and GIC (General Insurance Corporation) between 1987 and 1993, and to private players in 1993. ***At present, there are four types of mutual funds — Unit Trust of India, mutual funds sponsored by public sector banks, mutual funds sponsored by financial institutions, and private sector mutual funds.***

Resources mobilised by the MFs (including UTI) under various schemes rose substantially from ₹ 2,309 crore in 1987-88 to ₹ 13,021 crore in 1992-93 and further to as high as ₹ 22,118 crore in 1999-2000. However, this amount fell to ₹ 10,119 crore in 2001-02 and ₹ 4,582 crore in 2002-03. The most important has been the year 2007-08 with resource mobilisation by mutual funds in this year touching the highest ever level of ₹ 1,58,677 crore. However, due to global liquidity squeeze in 2008-09 following recessionary conditions, there were redemption pressures on the mutual funds. As a result, net mobilisation by mutual funds was negative at – ₹ 24,208 crore in 2008-09 (in other words, there was a net outflow of ₹ 24,208 crore). The situation improved considerably in 2009-10 with net mobilisation by mutual funds increasing to ₹ 78,347 crore. The years 2010-11 and 2011-12 were bad for the mutual fund industry as net mobilisation in these years was negative at – ₹ 48,600 crore and – ₹ 45,413 crore respectively. However, resource mobilisation by mutual funds rose significantly in recent years. It was as high as ₹ 3,43,418 crore in 2016-17. Resource mobilisation by mutual funds suffered a setback in 2017-18 and was only ₹ 2,71,800 crore – a decline of 20.8 per cent as compared with ₹ 3,43,418 crore in 2016-17.

Issues and Challenges Before Mutual Funds. As noted by Reserve Bank, despite a significant growth in the number of schemes and assets under management of mutual funds in recent years, their level of penetration remains limited in comparison with other countries. This is reflected in the small size of assets managed by them (amounting to less than 5 per cent of GDP as against 70 per cent in the USA, 61 per cent in France and 37 per cent in Brazil) and small share of household savings in units in mutual funds.[3] This indicates a vast potential that the mutual funds industry can tap in the Indian market. However, as correctly pointed by the Reserve Bank, limited involvement of the rural sector due to lack of awareness and limited banking services in the rural regions, could prove to be a constraining factor.

There are two other important issues raised by Reserve Bank in its *Annual Report* 2008-09:[4]

1. Although the share of equity-oriented schemes has increased considerably in recent years, they still account for less than 25 per cent of the assets of the industry. Most of the funds mobilised by mutual funds are through liquid/money market schemes, which remain attractive for parking of funds by corporates and other large institutional investors with a short-term perspective. A high dependence on corporates for funds implies a lesser role for retail investors whereas the basic objective of mutual funds is to enable more and more retail investors to participate in the capital market. Moreover, high dependence on corporate and other institutional investors makes the funds more volatile as these investors can withdraw funds at short notice.

2. The proliferation of schemes (1,000 to 5,000 variants) leads to confusion among investors. This problem can be partly tackled by linking the number of schemes permitted to the net owned funds.

Secondary Market

Secondary market refers to stock exchanges where existing securities can be regularly purchased and sold. These markets are an important element in mobilisation of resources. They enhance the efficiency of the flow of savings. The existence of these markets fulfils a basic need of the investors namely the liquidity. In these markets,

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holders of securities can easily dispose off their securities and obtain cash. Thus, viable secondary markets by providing marketability to securities encourage savers to take risk and make investments in the existing securities. In this process, savings of the households become available to private and public corporates which in turn greatly stimulate production activity.

NSE and BSE. The biggest stock exchange of India is the National Stock Exchange (NSE) which was set up in November 1992. It started its trading operations effective June 30, 1994. Only the debt market segment of the NSE was put into operation initially. The equity market segment of the NSE commenced its operation on November 3, 1994. The NSE very soon attained a much greater volume than the Bombay Stock Exchange which was the biggest stock exchange till NSE began its operations. NSE's growth was an unprecedented success for a new stock exchange. Competition from the NSE led to substantial reduction in the transactions costs which are now among the lowest in the world. Now, the NSE provides facilities for trading of equity instruments, warrants, debentures, preference shares etc. NSE has adopted fully automated screen-based trading system which allows trading members to trade from their office through a communication network. The exchange has opened membership to a number of cities.

The second largest stock exchange in India is the Bombay Stock Exchange (BSE). It was the first organised stock exchange established in India at Mumbai as far back as 1887. Presently, NSE and BSE account for almost the entire trading of scrips on Indian stock markets and most of the regional stock exchanges have been rendered redundant.

Performance indicators of BSE and NSE for the years 2015-16, 2016-17 and 2017-18 are presented in Table 48.1. As is clear from this Table, the cash market turnover for BSE and NSE together was ₹ 49,771 billion in 2015-16 and ₹ 60,542 billion in 2016-17. The derivative market turnover was ₹ 6,93,008 billion in 2015-16 and ₹ 9,43,773 billion in 2016-17. Both the BSE Sensex and S&P CNX Nifty were lower in 2015-16 as compared with 2014-15. The market capitalisation to GDP ratio for BSE was 80 per cent in 2016-17 and the market capitalisation ratio to NSE was 79 per cent. BSE Sensex at end-March 2017 was 29,621 and S&P CNX Nifty was 9,174.

The cash segment turnover in 2017-18 was ₹ 83,178 billion (an increase of 37 per cent *vis-à-vis* 2016-17) while the derivatives segment turnover was ₹ 16,49,883 billion (an increase of 75 per cent *vis-à-vis* 2016-17). The BSE Sensex and S&P CNX Nifty increased by 11.3 per cent and 10.2 per cent, respectively, in 2017-18 remaining generally resilient to multiple shocks during the year. BSE Sensex at end-March 2018 was 32,969 – an increase of 11.3 per cent *vis-à-vis* end-March 2017 when it was 29,621. S&P CNX Nifty at end-March 2018 was 10,114 – an increase of 10.7 per cent *vis-à-vis* end-March 2017 when it was 9,174. Market capitalisation to GDP ratio for BSE was 85 per cent and the market capitalisation to GDP ratio for NSE was 84 per cent in 2017-18.

FACTORS CONTRIBUTING TO THE GROWTH OF CAPITAL MARKET IN INDIA

The capital market has developed considerably in India during the last few decades, particularly during the period following the liberalisation of economic policy in the industrial, financial and foreign trade sectors in 1991 although there have been set-backs in certain years. What is to be noted is that despite the set-backs, the turnover and trading in the capital market is now much more than it was, say, a decade and a half back. Let us now discuss the factors that have contributed to the growth of capital market in India.

Table 48.1

Bombay Stock Exchange and National Stock Exchange – Performance Indicators

Indicators	*NSE*				*BSE*			
	2015-16	*2016-17*	*2017-18*		*2015-16*	*2016-17*	*2017-18*	
1. Sensex* (end period)	–	–	–	–	27,958	25,342	29,621	32,969
2. S&P CNX Nifty** (end period)	8,491	7,738	9,174	10,114	–	–	–	–
3. Cash segment turnover (₹ billion)	43,296.6	42,369.8	50,559.1	72,348	8,548.4	7,400.9	9,982.6	10,830
4. Derivatives segment turnover (₹ billion)	5,56,064.5	6,48,258.0	9,43,703.0	16,49,849	2,03,627.4	44,750.1	69.4	33
5. Market capitalisation to GDP ratio	79.5	68.0	78.9	84	81.3	69.3	80.0	85.0

* BSE Sensitive index

** S&P CNX Nifty for NSE

Source: Reserve Bank of India, *Annual Report* 2015-16 (Mumbai, 2016), Appendix Table 5, p. 174 and *Annual Report* 2016-17 (Mumbai, 2017), Appendix Table 5, p. 220.

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1. Establishment of development banks and industrial financing institutions. With a view to providing long-term funds to industry, the government set up the Industrial Finance Corporation of India (IFCI) in 1948, *i.e.,* soon after Independence. This was followed by the setting up of a number of other development banks and financial institutions like the Industrial Credit and Investment Corporation of India (ICICI) in 1955, Industrial Development Bank of India (IDBI) in 1964, Industrial Reconstruction Corporation of India (IRCI) in 1971, various State Financial Corporations (SFCs) at the State level, Unit Trust of India (UTI) in 1964, State Industrial Development Corporations, Life Insurance Corporations of India etc. In addition, 14 major commercial banks were nationalised in 1969. Another 6 banks were nationalised in 1980. These financial institutions and development banks have contributed significantly to the widening and strengthening of the capital market in India. ICICI Ltd. ceased to be a development bank after its merger with ICICI Bank with effect from March 30, 2002 while IDBI was converted into a bank in October 2004.

2. Legislative measures. The Government passed the Companies Act in 1956. This Act gave considerable powers to the government to control and direct the development of the corporate enterprises in the country. The Capital Issues (Control) Act was passed in 1947 to regulate investment in different enterprises, prevent diversion of funds to non-essential activities, and to protect the interest of investors. The Act was repealed in 1992 as it was felt that the Act had become too restrictive and was hampering the growth of the capital market.

3. Growth of underwriting business. Mainly due to the efforts of the public financial institutions and the commercial banks, the underwriting business in India has been growing rapidly. This has contributed significantly to the development of the capital market in India.

4. Growing public confidence. The early post-liberalisation phase witnessed increasing interest in the stock markets. The small investor who earlier shied away from the securities market and trusted the traditional modes of investment (deposits in commercial banks and post offices) showed marked preference in favour of shares and debentures. As a result, public issues of most of the good companies were oversubscribed many times. However, in the recent period, many retail investors have withdrawn from the securities market due to the lacklustre performance of many companies which has pushed down their share prices to low levels.

5. Increasing awareness of investment opportunities. The last few years have witnessed increasing awareness of investment opportunities among the general public. Business newspapers and financial journals (*The Economic Times, The Financial Express, Business Line, Business Standard, Mint, Business India, Business Today, Businessworld, Money Outlook* etc.), have made the people increasingly aware of new long-term investment opportunities in the securities market.

6. Setting up of SEBI. The Securities and Exchange Board of India (SEBI) was set up in 1988 and was given statutory recognition in 1992. Among other things, the Board has been mandated to create an environment which would facilitate mobilisation of adequate resources through the securities market and its efficient allocation.

7. Mutual funds. At present the mutual funds operating in the country are UTI, 6 mutual funds sponsored by public sector banks, 3 mutual funds sponsored by financial institutions (LIC, GIC and IDBI) and 45 mutual funds in the private sector. Net mobilisation of resources in 2007-08 was as high as ₹ 1,58,677 crore. However, because of global liquidity squeeze in 2008-09, corporates withdrew their investments from the mutual funds. As a result, net mobilisation in 2008-09 was negative at – ₹ 24,208 crore. There was a revival in 2009-10 because of easing of liquidity conditions and trends of market recovery. As a result, net mobilisation by mutual funds during 2009-10 rose to ₹ 78,347 crore. However, because of redemption pressures, there was again a negative net mobilisation in 2010-11 and 2011-12. Things improved considerably thereafter. Resource mobilisation by mutual funds was as high as ₹ 3,43,418 crore in 2016-17 and 2,71,800 crore in 2017-18.

8. Credit rating agencies. There are three credit rating agencies operating in India at present CRISIL, ICRA and CARE. CRISIL (the Credit Rating Information Services of India Limited) was set up in 1988, ICRA Ltd. (the Investment Information and Credit Rating Agency of India Limited) was set up in 1991 and CARE (Credit Analysis and Research Limited) was set up in 1993. Credit ratings by these agencies have been providing guidance to investors/ creditors for determining the credit risk associated with a debt instrument. This is likely to help in the healthy development of the capital market in future.

PROBLEMS OF INDIAN CAPITAL MARKET: THE PRE-REFORM PHASE

Problems of the Equity Market

According to Ajay Shah, in the pre-reform phase (*i.e.,* the pre-1991 period), the Indian equity market was confronted

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with a number of problems, the chief among them being as follows:[7]

1. As of 1992, the Bombay Stock Exchange (BSE) was a monopoly. It was an association of brokers, and imposed entry barriers, which led to increased costs of intermediation.

2. Trading took place by 'open outcry' on the trading floor, which was inaccessible to users. It was usual for brokers to charge the investor a much higher price from that actually traded at.

3. As with all trading floors, there was no price-time priority, so users of the market were not assured that a trade was executed at the best possible price.

4. A variety of manipulative practices prevailed, so that external users of a market often found themselves at the losing end of price movements. No strict action could be taken against errant brokers.

5. Retail investors, and particularly users of the market outside Mumbai, accessed market liquidity through a chain of intermediaries called 'sub-brokers'. Each sub-broker in the chain introduced a mark-up in the price and the investor thus had to pay a much higher price than the actual trade price.

6. The markets used 'future-style settlement' with fortnightly settlement. This means that trading was supposed to take place for a fortnight until a pre-determined 'expiration date'. Open positions on the expiration date only would go into actual settlement where funds and securities were exchanged. According to Shah, in practice, there was little discipline on ensuring a reliable fortnightly settlement cycle.

7. A peculiar market practice called *badla* prevailed in the capital market. *Badla* trade allowed buyers of stocks to postpone taking delivery by paying a mutually agreed rate of interest on the amounts owed to the sellers. Under the so-called 'badla methodology', stocks could be traded on payment of margins and settlement could be deferred. The badla system created huge counterparty risk[8] since settlements could be deferred indefinitely.[9]

8. The efficiencies of the exchange clearing house only applied for the largest 100 stocks. For other stocks, clearing and settlement were done bilaterally, which introduced further inefficiencies and costs.

9. The use of futures-style trading for a fortnight (or more) coupled with *badla* was fraught with counterparty risk. Counterparty risk in the small (at the level of one market participant) can sometimes become counterparty risk in the large (at the level of the entire market) owing to *cascading defaults*. The latter can lead to a payment crisis and the entire exchange could collapse. This has happened a number of times in Indian exchange market. In April 1995 in the context of M.S. Shoes, a default involving a total exposure of ₹ 18 crore led to a payment crisis on the BSE which halted the functioning of the exchange for three days.

10. Floor-based trading, inefficiencies in clearing and settlement, entry barriers into brokerage, and low standards of technology and organisational complexity led to an environment where order execution was unreliable and costly. It was typical for below 50 per cent of orders to obtain execution on a given day.

11. The final leg of the trade was physical settlement, where share certificates were printed on paper. This was intrinsically vulnerable to theft, counterfeiting, inaccurate signature verification, administrative inefficiencies and a variety of other malpractices. Moreover, the entire process of share transfer was time-consuming and cumbersome. For investors outside Mumbai, the entire process could well take six months or even more.

Problems of the Debt Market

According to Ajay Shah, the Indian debt market faced the following important problems in the pre-reform phase.

1. In 1992, debt trading took place without an exchange in the picture. Trades were bilaterally struck between known counterparties without anonymity. Personal and political influences impacted upon trade prices; each leg of the transaction was exposed to the credit risk of the other; dealer markets suffered from a fragmentation of orders and trades; and there was no price-time priority to ensure that each trade took place at the best price in the country.

2. The problem of credit risk served to narrow the market down to a 'club market', a set of participants with homogeneous credit risk.

3. The lack of anonymity made it easier to form and enforce cartels which would indulge in a lot of manipulative practices.

4. The debt market relied on dealers who, as with the Bombay Stock Exchange, did not unbundle their intermediation price from the transaction price. Therefore one could not shop around looking for a dealer with the lowest intermediation charges. Also, there was no guarantee of obtaining the best price, owing to the absence of price-time priority.

5. Trading took place by telephone in Mumbai. Hence, the debt market was effectively restricted to Mumbai.

6. Since trades took place bilaterally, trade prices were not centrally reported and observed, even *ex post.*

7. There were serious problems with the settlement of trades. The Reserve Bank tracks ownership of government

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securities in a database called the SGL. SGL was maintained manually.

8. Market participants faced the risk of an SGL request "bouncing". Suppose A sold to B and then B sold to C. When B sent the change of title to SGL, there was a risk that this request would bounce if the first trade (B buying from A) had not yet taken effect. Thus, the market participants resorted to the exchange of 'bankers receipts (BRs)' which were IOUs for bonds. The purchase and sale of these IOUs effectively constituted highly leveraged transactions in the absence of internal controls and risk management.

9. The protracted delays involved in settlement, coupled with the 'open interest' in the form of outstanding IOUs, led to grave reconciliation problems in the back offices of banks.

10. The complexity of reconciliation coupled with the inefficiency of the bank office made it easy for dealers to disguise soft loans to favoured counterparties. Banks' subordinate staff often committed these irregularities concealing them from their superiors. This was the mechanics of how funds from the banking system found their way into *badla* financing on the BSE. On account of this reason, Shah prefers to call the 'stock market scam of 1992' as the 'debt and stock market scam of 1992'.[10]

STRENGTHENING THE CAPITAL MARKET: THE POST-REFORM PHASE

In the post-reform phase (*i.e.*, the period after 1991), the Government of India has initiated a number of steps to strengthen the capital market. A brief discussion of important measures follows.

Steps to Strengthen the Government Securities Market

1. The auction system for the sale of Government of India medium and long-term securities was introduced from June 3, 1992. Some innovative instruments, such as, conversion of auction Treasury Bills into term securities, Zero Coupon and Capital Indexed Bonds, Tap Stocks and partly paid stocks were introduced.

2. 364-day Treasury Bills auctions were introduced from April 28, 1992 and 91-day Treasury Bills auctions from January 8, 1993. 14-day Treasury Bills were introduced on June 6, 1997, while 182-day Treasury Bills were reintroduced on May 26, 1999. Auctions of 14-day Treasury Bills and 182-day Treasury Bills were discontinued from May 14, 2001. However, auction of 182-day Treasury Bills was resumed from April 5, 2005.

3. The Government of India set up the Securities Trading Corporation of India (STCI) to develop institutional structure for a vibrant secondary market in government securities. STCI was set up with total capital of ₹ 500 crore and it commenced operations from June 1994.

4. A scheme of 14-day Intermediate Treasury Bills was introduced effective from April 1997 to enable State governments, foreign central banks and other specified bodies with whom the Reserve Bank had an arrangement to invest their temporary surplus funds.

5. A system of Primary Dealers was established in March 1995 and the guidelines for Satellite Dealers were issued in December 1996.

6. Market orientation to issues of government securities paved the way for the Reserve Bank to activate the open market operations as a tool of market intervention.

7. The practice of automatic monetisation of the Central government budget deficit through *ad hoc* Treasury Bills was replaced with effect from April 1, 1997 by a new scheme of Ways and Means Advances (WMA).

8. The Delivery *versus* Payment system (D*v*P) was introduced in 1995 for the settlement of transactions in government securities. A screen-based trade reporting system with the use of VSAT Communication Network complemented by a centralised Subsidiary General Ledger (SGL) accounting system was put in place.

9. The Negotiated Dealing System (NDS) (Phase I) was operationalised in February 2002 to enable online electronic bidding facility in the primary auctions of Central/ State government securities.

10. Since timely information is a critical factor in evolving the efficient price discovery mechanism, improvements were brought in transparency of operations and data dissemination.

11. A practice of pre-announcing a calendar of treasury bills and government securities auctions to the market was introduced.

12. Foreign institutional investors were allowed to set up 100 per cent debt funds to invest in government (Central and State) dated securities in both primary and secondary markets.

13. Retail trading in government securities at select stock exchanges commenced in January 2003.

Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) set up in 1988 was given statutory recognition in 1992 on recommendations of the Narasimham Committee. Among other things, the SEBI has been mandated to create an

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environment which would facilitate mobilisation of adequate resources through the securities market and its efficient allocation. The purposes and aims of SEBI are as follows: (1) regulating the business in stock markets and other securities markets; (2) registering and regulating the working of stock brokers and other intermediaries associated with the securities markets; (3) registering and regulating the working of collective investment schemes including mutual funds; (4) promoting and regulating the self-regulatory organisations; (5) prohibiting fraudulent and unfair trade practices relating to securities markets; (6) promoting investors' education and training of intermediaries of securities market; (7) prohibiting insider trading in securities; (8) regulating substantial acquisition of shares and takeover of companies; and (9) performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947 and Securities Contracts (Regulation) Act, 1956, as may be delegated to it by the Central government.

SEBI has been vested with wide-ranging powers. ***Firstly***, to oversee constitution as well as the operations of mutual funds including presentation of accounts, following the decision to allow the entry of private sector and joint sector mutual funds. ***Secondly***, all stock exchanges in the country have been brought under the annual inspection regime of SEBI for ensuring orderly growth of stock markets and investors protection. ***Thirdly***, with the repealing of the Capital Issues (Control) Act, 1947, in May 1992, SEBI has been made the regulatory authority in regard to new issues of companies. An amendment to the SEBI Act (1992) carried out on March 25, 1995 has empowered SEBI to register and regulate new intermediaries in the capital market. With this empowerment, ***all intermediaries associated with the securities market are now regulated by SEBI.***

National Stock Exchange of India

As stated earlier, NSE was set up in November 1992 and was owned by IDBI, UTI and other public sector institutions. It commenced its operations in 1994. NSE is a securities exchange which marks a radical break with the past. According to Ajay Shah, the regime in which trading on NSE operates is characterised by four key innovations:[11] (1) The physical floor was replaced by anonymous, computerised order-matching with strict price-time priority. (2) The limitations of being in Mumbai, and the limitations of India's public telecom network, were avoided by using satellite communications. (3) NSE is not 'owned' by brokers. It is a limited liability company, and brokers are franchisees. Therefore, NSE's staff is free of pressures from brokers and is able to perform its regulatory and enforcement functions more effectively. (4) Traditional practices of unreliable fortnightly settlement cycle with the escape clause of *badla* were replaced by a strict weekly settlement cycle without *badla*.

As stated earlier, equity trading at NSE commenced in November 1994. The BSE responded rapidly by moving to similar technology in March 1995. According to Ajay Shah, the improvements that accompanied this regime were are follows: ***(i) transparency*** — users could look at a price on a computer screen before placing on order; ***(ii) anonymity*** — electronic trading is completely transparent about prices and quantities, and completely opaque about identities; ***(iii) competition in the brokerage industry*** — as a result of NSE, about 1,000 new brokerage firms have entered the market. This has reduced transaction costs sharply (through lower brokerage fees); ***(iv) operational efficiency*** — automation eliminated the vagaries of manual trading; and ***(v) gains outside Mumbai*** — NSE's satellite based trading gave equal access to the trading floor from all locations in India. This has helped the users outside Mumbai and has been a major impetus to the development of financial sector outside Mumbai.

NSE is now the world's largest derivative exchange ahead of NYSE Euronext and Nasdaq. It currently operates with 10 trading engines and handles 450 million orders every day with 50,000 other messages per second for trading across asset classes. NSE has more than 2,00,000 trading terminals in over 2,000 towns and cities. In fact, more than 45 per cent of the total cash market retail turnover of NSE in 2011-12 came from retail investors from Tier-III cities. Its trading terminal NOW (Neat on Web) is one of the country's largest private cloud with more than 36,000 log-ins daily. Trading at NSE is at the 'speed of light' as it can handle two billion order messages per second. According to its chief technology officer, Ravi Apte, NSE has "attained nirvana" in technology.[12]

National Securities Clearing Corporation

As stated earlier, trading in the securities market in the pre-reform phase was fraught with counterparty risks. Small counterparty risks could turn into large counterparty risks owing to cascading effects, jeopardising the functioning of the entire market. To tackle this problem, the National Securities Clearing Corporation (NSCC) was set up in 1996. Effective on July 4, 1996, the NSCC started guaranteeing all trades on NSE. "This means that when A and B make a trade, NSCC interposes itself between them. If A was supposed to buy from B, then NSCC buys from B and NSCC sells to A. If either A or B default, the NSCC still meets the obligation for the other leg of the trade. Thus every trade that takes place is freed from the risk of the

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counterparty defaulting. This automatically ends the risk of cascading failures generating a payments crisis."[13]

Dematerialisation

The final leg of a transaction is where the title on a security is changed from the seller to the buyer. Since share certificates in India were printed on paper, trading in them was fraught with operational cost and risk. Theft or counterfeiting of share certificates gave rise to a number of criminal activities. To tackle this problem, National Securities Depository Limited (NSDL) was set up in November 1996. This was followed by the setting up of the Central Securities Depository Ltd. (CSDL). The depository maintains a computer record of ownership of securities and dispenses with physical share certificates. This cuts down the hazards related with physical trading in share certificates and also reduces the transactions costs substantially.

SEBI AND CAPITAL MARKET DEVELOPMENT

To introduce improved practices and greater transparency in the capital markets in the interest of healthy capital market development, a number of steps have been taken by SEBI. The important steps are:

1. SEBI has drawn up a programme for inspecting stock exchanges. Under this programme, inspections of some stock exchanges has already been carried out. The basic objective of such inspections is to improve the functioning of stock exchanges.

2. SEBI has introduced a number of measures to reform the primary market. The objective is to strengthen the standards of disclosure, introduce certain procedural norms for the issuers and intermediaries, and remove the inadequacies and systemic deficiencies in the issue procedures. For example, an advertisement code has been laid down to ensure that the advertisements are fair and do not contain statements to mislead the investors; a system of appointing SEBI representatives to supervise the allotment process has been introduced to minimise malpractices in allotment of oversubscribed issues; prudential norms have been laid down for rights issues, etc.

3. The process of registration of intermediaries such as stock brokers and sub-brokers has been provided under the provisions of the Securities and Exchange Board of India Act, 1992. The registration is on the basis of certain eligibility norms such as capital adequacy, infrastructure etc. According to the SEBI (Stock Brokers and Sub-Brokers) Rules 1992 announced on August 20, 1992, no person can act as a stock-broker for the purpose of buying/selling or dealing in securities, unless he holds a certificate granted by SEBI and conditions for grant of such certificates have been laid down in the rules. SEBI issued regulations relating to stock-brokers and sub-brokers in October 1992 which, *inter alia,* cover registration of brokers and sub-brokers, their general obligations and responsibilities, procedures for inspection of their operations and actions to be initiated in case of default.

4. Through an order under the Securities Contracts (Regulations) Act, 1956, SEBI has directed the stock exchanges to broad-base their governing boards and change the composition of their arbitration, default and disciplinary committees. The broadbasing of the governing boards of the stock exchanges would help them function with greater degree of autonomy and independence so that they become truly self-regulatory organisations.

5. Merchant banking has been statutorily brought under the regulatory framework of SEBI. The merchant bankers have to be authorised by SEBI. They will have to adhere to stipulated capital adequacy norms and abide by a code of conduct which specifies a high degree of responsibility towards inspectors in respect of the pricing and premium fixation of issues.

6. The SEBI (Prohibition of Insider Trading) Regulations, 1992 were notified in 1992, which was framed to deter the practices of insider trading in the securities of listed companies. SEBI notified the SEBI (Prohibition of Insider Trading) Regulations, 2015 on January 15, 2015 which has replaced the earlier regulations of 1992 with effect from May 15, 2015. The new regulations strengthen the legal and enforcement framework, align Indian regime with international practices, provide clarity with respect to the definitions and concepts, and facilitate legitimate business transactions.

7. SEBI issued a separate set of guidelines for development financial institutions in September 1992 for disclosure and investment protection regarding their raising of funds from the market. As per the guidelines, there is no need for promoter's contribution. Besides, underwriting is not mandatory. Moreover, free pricing is permitted subject to consistent track record for three years and credit rating is compulsory for debentures and bonds of more than 18 months.

8. SEBI has notified the regulations for mutual funds. For the first time mutual funds are governed by a uniform set of regulations which require them to be formed as trusts and managed by a separate asset management company (AMC) and supervised by a board of trustees or trustee company. The SEBI (Mutual Fund) Regulations also provide

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for an approval of the offer documents of schemes by SEBI. There will also be certain investment restrictions for AMCs. The advertisement code prescribes norms for fair and truthful disclosures by the mutual funds in advertisements and publicity materials. The regulations are intended to ensure that the mutual funds grow on healthy lines and investors' interests are protected.

9. To bring about greater transparency in transactions, SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transaction price and brokerage separately in the contract notes issued to their clients. They must also have their books audited and audit reports filed with SEBI.

10. The 'Banker to the issue' has been brought under purview of SEBI for investor protection. Unit Trust of India (UTI) has also been brought under the regulatory jurisdiction of SEBI.

11. The Companies (Amendment) Ordinance (October 31, 1998 and January 7, 1999) allows companies to buy back their own shares subject to regulations laid down by SEBI. The new Sections (77A and 77B) in the Ordinance lay down the provisions/restrictions concerning buy back of shares. A company can finance its buy back out of (*i*) its free reserves, (*ii*) the securities premium account or (*iii*) proceeds of an earlier issue other than fresh issue of shares made specifically for buyback purposes.

12. SEBI has dispensed with the requirement to issue shares with a fixed par value of ₹ 10 and ₹ 100 and has given freedom to companies to determine the par value of shares issued by them.

13. SEBI's regulations for Collective Investment Schemes (CIS) were notified on October 15, 1999.[14] Under the SEBI Act and Regulations framed thereunder, no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing collective investment schemes were required to apply for registration by December 14, 1999. An existing scheme which does not obtain registration from SEBI shall have to wind up and repay the money to the investors.

14. An Ordinance promulgated on October 28, 2002 gave the following four powers to SEBI: (*i*) SEBI can search an entity's premises and seize documents; (*ii*) It can impound cash proceeds and securities connected to any transaction it is investigating and can even freeze bank accounts; (*iii*) Regardless of the nature or scale of market violation, SEBI could earlier fine an offender a maximum of ₹ 5 lakh. The Ordinance increased this limit manifold — in market manipulation or insider trading violations, to ₹ 25 crore or three time the profits made by the entity concerned, whichever is higher and for other violations like non-disclosures, upto ₹ 1 crore; and (*iv*) The size of the SEBI Board has been increased. The idea behind this is to move from individual-based to group-based decision making, thereby reducing the possibility of errors or bias. Moreover, insider trading and market manipulation has been defined clearly. The Ordinance was followed by the Securities and Exchange Board of India (Amendment) Act, 2002 adopted in December 2002.

15. In order to provide an additional route for raising funds in the domestic market, SEBI permitted listed companies in May 2006 to raise funds in the form of 'Qualified Institutional Placement' (QIP).

16. In September 2006, SEBI widened the range of international entities that can invest in the stock market by including an institution established as incorporate outside India as a pension fund, mutual fund, investment trust, insurance company and reinsurance company as registered FIIs (Foreign Institutional Investors). The list would also include international or multilateral agencies, foreign government agencies or foreign central banks.

17. In August 2007, SEBI issued guidelines for overseas investment by VCF (Venture Capital Funds).

18. SEBI has stipulated that Permanent Account Number (PAN) would be the sole identification number for all participants in the securities market, irrespective of the amount of transaction with effect from July 2, 2007.

19. In October 2007, SEBI prohibited FIIs and their sub-accounts from issuing or renewing Participatory Notes using offshore derivative instruments like futures and options.

20. QFIs (Qualified Financial Investors) were allowed to directly invest in the Indian equity market in January 2012. This was done to widen the class of investors, attract more foreign funds, reduce market volatility, and deepen the Indian capital market. ***The QFIs shall include individuals, groups, or associations, resident in a foreign country that meet specified conditions. QFIs do not include FIIs/sub-accounts.*** Earlier, only FIIs/sub-accounts and non-resident Indians (NRIs) were allowed to directly invest in the Indian equity market. Under this arrangement, a large number of QFIs, in particular, a large set of diversified individual foreign nationals who were desirous of investing in the Indian equity market, did not have direct access to it. The RBI and SEBI have issued the relevant circulars on January 13, 2012 to operationalise this scheme.

21. On October 23, 2013, SEBI allowed companies entering into mergers and acquisitions (M&A) deals to include preferential clauses. These clauses include 'right of

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first refusal, tag-along and drag-along' in their share purchase agreement. The right of refusal gives one of the parties in all M&A deals, the first option to buy-out its partner if the latter wishes to exit from the agreement at a later stage. Tag-along and drag-along clauses allow one of the partners to join the other party in cases like further acquisition or sell-out deals. These changes are likely to help boost the interest of foreign investors, who tend to prefer such clauses in their deals. The demand for allowing such clauses had been gaining ground for quite sometime because certain high-profile M&A deals, including the Diageo-United Spirits deal and Cairn-Vedanta deal, had to face regulatory hurdles amid lack of clarity on regulations on such clauses.

22. On December 23, 2013, SEBI announced a slew of measures to make fund-raising simpler. For this purpose, SEBI has made the grading system for initial public offerings (IPO) voluntary. This will help to boost the dormant primary market and reduce the reliance on rating agencies, which have recently come under the scanner globally for their role in financial markets. In line with the new companies law, a host of companies — non-banking financial companies (NBFCs) registered with Reserve Bank of India, housing finance companies and infrastructure debt funds — have been allowed to file shelf prospectus[15] for issuance of non-convertible debt securities that would be valid for multiple offers within a year. Companies that have listed their shares or debentures in stock exchanges for at least three years, have also been allowed to file such shelf prospectus, provided they have a net worth of ₹ 500 crore and a track record of three years of distributable profits. So far, the Companies Act, 1956 had only allowed banks and public financial institutions to file such prospectus.

23. Securities Laws (Amendment) Act, 2014 gives powers to SEBI to conduct search and seizure operations and crackdown on defaulters and manipulators. In the absence of clear rules for deposit-taking firms, hundreds of entities had been raising illegitimate money from the public as chit funds, ponzi schemes and guaranteed return programmes for several years without being questioned by any regulator.

24. On June 19, 2014, SEBI announced a slew of measures to boost equity issuances by India Inc. and help rejuvenate the primary market. In a move that will level the playing field between private and State-owned companies, SEBI has proposed that even public sector undertakings (PSUs) would need to have at least 25 per cent public float, compared with the earlier cap of 10 per cent. The regulator said the government would be given three years to meet the holding requirement. "Under the current rule, while non-PSUs are required to have a minimum 25 per cent public shareholding, State-run firms are required to have only 10 per cent. That is discriminatory and inconsistent with the broader market design," SEBI said in a statement. "SEBI believes that rules for the market should be uniform across companies and should be promoter-neutral," it added. According to estimates, ***the government will have to dilute ₹ 60,000 crore worth of its stake in 36 PSUs.***

25. The new SEBI Foreign Portfolio Investment Regulations which have come into effect from June 1, 2014 have enabled to rationalise/harmonise various foreign portfolio investment routes and establish a unified/simple regulatory framework. As part of risk based approach towards customer identity verification (KYC), Foreign Portfolio Investors (FPIs) have been categorised into three major categories: Category I, II and III where the documentary requirements are simplest for Category I and most stringent for Category III.

As is clear from the above description, SEBI has introduced a number of measures to reform India's capital market in recent years. ***By improving market efficiency, enhancing transparency, and preventing unfair trade practices, it has succeeded to a considerable extent in bringing up the Indian market to international standards.*** The important developments can be highlighted as under: (1) the issuers complying with the eligibility criteria are allowed freedom to issue the securities at market determined rates; (2) the secondary market has overcome the geographical barriers by moving to screen-based trading; (3) all kinds of securities — debt and equity, government and corporate — are traded on exchanges, side by side; (4) trades enjoy counterparty guarantee; (5) the trading cycle has been shortened to a day and trades are settled within 2 working days; (6) physical security certificates (and dependent risks) have almost disappeared; (7) a variety of derivatives are permitted; (8) corporate governance has improved significantly; (9) the confidence of international investors in the Indian securities market has increased considerably with the result that a large number of FIIs (foreign institutional investors) are registered with SEBI; and (10) the Indian market is getting integrated with the global market.[16]

CHALLENGES REQUIRING ATTENTION

The Indian capital market has witnessed a radical transformation within a period of just two-and-a-half decades. During the early part of 1990s, the ranking of Indian capital market with reference to global standards of efficiency, safety, market integrity etc., was low. With reference to the risk indices, in particular, the Indian capital market was regarded as one of the worst as it figured almost at the bottom of the league. However, the scenario has now

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completely changed. Because of extensive capital market reforms carried out over the period of the last two-and-a-half decades, the setting up and extension of activities of NSE, and steps taken by SEBI, the Indian capital market is now ranked in the top league. In fact, it is now considered to be way ahead of many developed country capital markets.[17]

A significant feature of the primary market activity after abolition of capital controls has been that the corporates attempted to diversify the range of instruments. A wide variety of innovative/hybrid instruments were introduced to suit varied needs of investors and issuers/borrowers. Some of the instruments which became quite popular were secured premium notes (SPNs) with detachable warrants, non-convertible debentures with detachable equity warrants, zero-interest equity shares with detachable equity warrants, fully convertible cumulative redeemable preference shares etc. Despite set-back in some years due to stock market scams, the sentiments look quite positive. However, there are some issues that require attention:

1. ***There is a general lack of interest among Indian households in investing in capital market.*** Higher networth retail investors do apply for shares at the time of initial public offerings of well-known companies. However, median-income households remain hesitant participants in Indian equity markets. Moreover, average individual investors are still wary of investing in stocks and corporate bonds. According to Jamini Bhagwati, "this is partly because the free float of shares of well-managed companies is limited since such stocks are held closely by promoters, FIIs (foreign institutional investors), domestic institutional investors and mutual funds. Additionally, the episodic yet steady flow of news about collusion across promoters, managers and others in a variety of scams dampens retail-investor sentiment."[18]

2. ***In the last twenty years, SEBI has been led by administrative-service government officers with little formal training in finance and no market experience.*** Shortcomings in SEBI leadership have resulted in continued deficiencies in institution-building within SEBI.[19] On account of this reason, Jamini Bhagwati advocates the adoption of a more rigorous process in the selection of key SEBI personnel so that only persons with adequate knowledge of finance and economics and market experience find a place in SEBI.

3. ***Many FIIs use opaque instruments like PNs (participatory notes) to invest in Indian stock markets.*** As stated in Chapter 39, PNs hide the identity of foreign investors. Speculative flows can occur through PNs and create uncertainty and volatility in the stock market. The ultimate investor of a PN is not identified and some of the PNs may also be associated with illegal activities such as smuggling or the drugs trade. Every time, the government-SEBI have sought greater transparency about the beneficiary ownership and details of PNs, FIIs have sold stocks precipitously, and Indian share prices have tumbled. This has created 'panic' situations. Nevertheless, mechanism has to be evolved to seek and ensure more details about PN structures.

4. Despite increasing participation of domestic institutional investors in the capital market, it is the FIIs that call the shots due to the vast amount of resources at their command. However, as correctly pointed out by R.H. Patil, ***"The operations of the FIIs in India are often sporadic as their buy and sell decisions are governed by global strategies in which the Indian market continues to be a marginal player."***[20] Therefore, external shocks can destabilise the Indian capital market at any time and it is necessary to take adequate precautionary steps to avoid/prevent this possibility.

APPENDIX TO CHAPTER 48: MEASURES TO DEVELOP CORPORATE BOND MARKET

A well developed corporate bond market complements a sound banking system in providing an alternative source of finance to the real sector for its long-term investment needs. An active corporate bond market also helps in the diversification of risks in the financial system. In order to enable public and private sector firms to borrow for longer maturity periods in local currency to meet their investment needs and avoid balance sheet mismatches and foreign currency exposures, there is a need to accelerate the development of local currency bond market. An active corporate bond market could also provide institutional investors such as insurance companies and provident and pension funds with quality long-term financial assets, helping them in matching their assets and liabilities.

Report of the Working Group for Development of Corporate Bond Market

The Financial Stability and Development Council Sub-committee (FSDC-SC) in its meeting held on September 10, 2015 decided to constitute a Working Group on Corporate Bonds to guide the implementation of the recommendations made by all the earlier Committees and suggest further measures that may be taken to develop the corporate debt market in the light of evolving macroeconomic and financial market conditions. Accordingly, a Working Group was

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constituted under the chairmanship of Harun Rashid Khan, Deputy Governor, Reserve Bank of India. The Working Group submitted its report to RBI Governor on August 12, 2016.

Structural Features Impinging on the Development of Corporate Bond Market. The Group pointed out the following structural features of the corporate bond market in India impinging on the development of a deep corporate bond market:[21] (*i*) The corporate bond issuance is dominated by private placements as these account for more than 95 per cent of the total issuance of corporate debt (2014-15). (*ii*) A majority of the issuances are concentrated in the 2-5 year tenor. (*iii*) ***The investor base is limited/narrow*** as the investment mandates of institutional investors such as insurance companies, pension funds and provident funds, despite review of the minimum credit rating from time to time, provide limited space for going down the credit curve as the investments are made in fiduciary capacity to protect the interests of subscribers. (*iv*) Small outstanding stock of individual issuances is one of the key factors impacting secondary market trading as reissuances have not picked up in spite of the enabling provisions by SEBI. (*v*) Functional trading platform is not available; the existing DVP-III settlement introduced by stock exchanges have found no takers. (*vi*) There is total lack of liquidity in credit risk protection instruments like Credit Default Swaps (CDS). (*vii*) Stamp duties on corporate bonds across various States have not been standardised; tax regime for financial instruments remains one of the key drivers of investor interest. (*viii*) There are inherent structural incentives for borrowers to prefer bank financing, e.g., cash credit system and no disincentive for enjoying unutilised working capital limits. (*ix*) As the corporate debt market cannot be looked as totally detached from the sovereign bond market, this market may get a fillip as the interest rates come down with the inflation and fiscal consolidation targets being achieved. (*x*) In the current context, many large non-financial corporates who should normally be the preferred issuers of bonds are leveraged and hence cannot access either loan from banks or bond financing through market mechanism.

Recommendations. The main recommendations made by the Working Group for the development of the corporate bond market are as under: (*i*) The issuers coming out with frequent debt issues with the same tenor during a quarter may club them under the same umbrella which, in turn, would increase the float in the market, thus enhancing its liquidity. (*ii*) Necessary amendments may be made in FEMA regulations to allow investment by FPIs (Foreign Portfolio Investors) in unlisted debt securities. Amendments may also be carried out in both FEMA notification and SEBI guidelines to facilitate direct trading in corporate bonds by FPIs in the OTC segment and on an electronic platform of a recognised stock exchange, subject to certain safeguards, without involving brokers. (*iii*) Stock exchanges may operationalise market making scheme in corporate bonds. Regulated entities like banks, PDs (primary dealers), in addition to brokers, may be encouraged by the regulators to act as market makers in corporate bond market subject to appropriate risk management framework. (*iv*) The Electronic Book Mechanism for private placement of debt securities, currently mandatory for issuances over ₹ 500 crore, may be extended to all primary market issuances. (*v*) A uniform valuation methodology available on a daily basis may be followed by all the regulated entities for valuation of their holdings of corporate bonds. (*vi*) Credit rating agencies may be mandated to strictly adhere to the regulatory norms with regard to timely disclosure of defaults on the stock exchanges and their own website. (*vii*) A centralised database for corporate bonds covering both primary and secondary market segments may be established expeditiously. (*viii*) An electronic dealing platform with CCP (Central Counter Party) facility with appropriate risk management framework may be introduced. Market participants may be consulted to develop a commonly acceptable market repo agreement for execution among the market participants. Entities authorised as market makers in corporate bond market, including the brokers, may be allowed to participate in the repo market executed on electronic platform linked to guaranteed settlement. (*ix*) Corporate bond index may be introduced by the Stock Exchanges/other entities. (*x*) The Working Group recommended that during the initial phase, the upper limit for PCE (Partial Credit Enhancement) by the banking system as a whole may be enhanced to a higher limit with no single bank having exposure of more than 20 per cent of the bond issue size by end August 2016. (*xi*) ***Large corporates with borrowings from the banking system above a cut-off level may be required to tap the market for a portion of their working capital and term loan needs.*** (*xii*) After the measures like introduction of tripartite repo and repo on electronic dealing platform with CCP facility gain some traction, RBI may explore the possibility for accepting corporate bonds for LAF (Liquidity Adjustment Facility) operations with suitable risk management framework including rating requirements and appropriate haircuts. (*xiii*) Legal basis may be examined expeditiously to remove the technical obstacles for RBI to accept corporate bonds as collateral under LAF repo as and when the Scheme is introduced. (*xiv*) The stamp duty on debentures should be made uniform across States and be linked to the tenor of securities within an overall cap. Reissuance of the same security should be

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included for the purpose of the cap, in order to encourage reissuance.

RBI Proposals to Develop Corporate Bond Market

For years, it has been said that the Indian economy is too bank-dependent. The reason cited for this was the lack of depth in the corporate bond market. But it is always a chicken-and-egg situation. Investors complained about the lack of quality credit. Issuers complained about the lack of investors. To tackle this issue, just ten days before stepping down from office, the RBI governor Raghuram Rajan unleashed a number of measures (on August 25, 2016) to develop the corporate bond market, taking into account the recommendations of the Khan Committee. The main measures announced were as follows:

1. As a first step, RBI said that it will allow banks to provide greater credit enhancement to bond issues. Credit enhancement is essentially a way to improve the credit rating of a bond issue. This is done by structuring the bond market in such a way that the bank provides a source of assurance or guarantee to service the bond. Until now, banks were allowed to provide PCE (Partial Credit Enhancement) to the extent of 20 per cent of the bond issue. Now, ***the banking system can provide credit enhancement upto 50 per cent, even though individual banks can only have exposure of upto 20 per cent.*** The decision should allow lower-rated borrowers to come to the bond market and permit regulated investors (like insurance companies) to invest in bonds issued by a wider range of companies.

2. RBI suggested the creation of a new segment of borrowers called 'specified borrower'. A specified borrower is defined as any one who has aggregate fund-based credit limit of ₹ 25,000 crore in 2017-18, ₹ 15,000 crore in 2018-19 and ₹ 10,000 crore from April 1, 2019 onwards. When this specified borrower comes back to banks to borrow more, half of any borrowing over and above the aggregate fund-based credit limit will attract additional provisions and higher risk weights. ***Banks, however, can subscribe to bonds issued by these specified borrowers subject to a condition that these bonds will be divested over time.*** The idea, very simply is to force large borrowers towards market borrowings and reduce the systemic risk created by the concentration of bank funds in a handful of companies.

3. To provide more heft to corporate bonds, RBI also said that it will eventually start accepting corporate bonds as collateral at its LAF (Liquidity Adjustment Facility) window. This essentially means that ***banks can use corporate bonds as security to borrow from RBI.*** This measure, however, will require changes in the RBI Act and necessary steps in this direction have been initiated.[22]

4. Participation in corporate bond market has been traditionally restricted to regulated entities like banks, PDs (primary dealers), mutual funds, insurance companies, etc. In order to encourage activity in the corporate bond market, ***brokers authorised as market makers have been allowed by the RBI to participate in the corporate bond repo market.*** This measure is expected to meet their funding and securities requirement arising out of market making activities.

5. Foreign investors have been allowed to trade directly in corporate bonds rather than through a broker.

6. To further encourage the overseas Rupee bond market, banks are being permitted to issue Rupee bonds overseas (Masala Bonds)[23] for their capital requirements and for financing infrastructure and affordable housing.

7. In order to further develop the repo market, a broad framework for introduction of electronic dealing platforms for repo in corporate bonds will be designed in consultation with SEBI.

Steps Announced in Union Budget 2018-19

The following three announcements made in the Union Budget 2018-19 (presented on February 1, 2018) indicate the government's determination to deepen the corporate bond market:

1. "Reserve Bank of India has issued guidelines to nudge corporates access bond market. SEBI will also consider mandating, beginning with large corporates, to meet about one-fourth of their financing needs from the bond market."

This means that ***large corporations will be asked to meet 25 per cent of funding needs through the corporate bond market.***

2. "Corporate bonds rated 'BBB' or equivalent are investment grade. In India, most regulators permit bonds with the 'AA' rating only as eligible for investment. It is now time to move from 'AA' to 'A' grade ratings. The government and concerned regulators will take necessary action."[24]

This means ***persuading regulatory recognition for 'A' rating category bond investments.***

3. "We will take reform measures with respect to stamp duty regime on financial securities transactions in consultation with the States and make necessary amendments to the Indian Stamp Act."

This means ***pushing for uniform stamp duty on bond issuances across the country.***

Because of the steps taken to develop the corporate bond market in recent years, there has been significant improvement in turnover in this market. This is clear from

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the fact that the average daily turnover in the corporate bond market increased sharply to ₹ 74.6 billion during 2017-18 from ₹ 61 billion a year ago. Net outstanding corporate bonds increased by 14.3 per cent on year-to-year basis to ₹ 27.4 trillion by end-March 2018, about 16.3 per cent of GDP.

NOTES

1. S.B. Gupta, *Monetary Economics: Institutions, Theory and Policy* (Delhi, 1988), p. 67.
2. Government of India, *Economic Survey* 2016-17 (Delhi, 2017), Volume II, Table 5, p. 98.
3. Reserve Bank of India, *Annual Report* 2008-09 (Mumbai, 2009), Box II.9, p. 155.
4. *Ibid.*, Box II.29, p. 155.
5. Reserve Bank of India, *Annual Report* 2015-16 (Mumbai, 2016), pp. 30-31.
6. Reserve Bank of India, *Annual Report* 2016-17 (Mumbai, 2017), pp. 43-4.
7. Ajay Shah, "Institutional Change in India's Capital Markets", *Economic and Political Weekly*, January 16-23, 1999, pp. 183-94.
8. For meaning of 'badla' and 'counterparty risk', see 'Definition of Terms Used in the Book' at the beginning of this book.
9. Following the stock market scam of 1992, the government banned *badla* in 1993. However, due to the lobbying of the brokers, the government allowed *badla* trading again in 1996. *Badla* trading was banned for good in 2001. See Jamini Bhagwati, "Liberalizing Indian Capital Markets: Highly Successful Reforms and the Unfinished Agenda", in Rakesh Mohan (ed.), *India Transformed: 25 Years of Economic Reforms* (New Delhi, 2017), p. 434.
10. Ajay Shah, *op. cit.*, p. 190.
11. *Ibid.*, p. 188.
12. *Business Standard*, August 21, 2012, p. 6.
13. Ajay Shah and Susan Thomas, "Securities Markets: Towards Greater Efficiency", in Kirit S. Parikh (ed.), *India Development Report 1997* (Delhi: Oxford University Press, 1997), p. 175.
14. CIS includes any scheme or arrangement with respect to property of any description, which enables investors to participate in the scheme by way of subscriptions and to receive profits or income or produce arising from the management of such property.
15. Shelf prospectus is a type of public offering where certain issuers are allowed to offer and sell securities to the public without a separate prospectus for each act of offering.
16. G.N. Bajpai, *The Securities Market* (New Delhi, 2004), p. 18.
17. R.H. Patil, "Current State of the Indian Capital Market", *Economic and Political Weekly*, March 18, 2006, p. 1001.
18. Jamini Bhagwati, *op. cit.*, p. 439.
19. *Ibid.*, p. 441.
20. R.H. Patil, "Capital Market — Many Unfinished Tasks", *The Hindu Survey of Indian Industry*, 1997, p. 461.
21. Reserve Bank of India, *Report of the Working Group on Development of Corporate Bond Market in India*, August 2016, p. 6.
22. In this context, see the following comments of the then Governor of Reserve Bank in a speech delivered on August 26, 2016, ***"One way to bring liquidity to corporate debt is to enable them to be used as collateral in repo transactions with the Central Bank",*** with appropriate haircuts, of course. As banks become able to borrow against their high quality corporate bonds, yields will fall, and more issuers will come to the market. With this in mind, we have initiated the process with the government to amend the RBI Act to allow the RBI to conduct repos of corporate bonds with banks and other financial institutions." See Raghuram G. Rajan, *I Do What I Do* (New Delhi, 2017), p. 78.
23. For definition of 'Masala Bonds', see 'Definition of Terms Used in the Book' at the beginning of the book.
24. The highest credit rating that a bond can receive is AAA, which signifies a very strong financial position and ability to pay interest obligations on all its outstanding loans. Next in the hierarchy is AA, followed by A and then BBB rated bonds.
    Globally, bonds rated upto BBB are considered as investment grade. This does not mean that there can be no default in payments from issuers. Rather, it signifies a low probability of default.

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Chapter

INSTITUTIONAL FINANCING

In this chapter, we propose to discuss:

- The evolution of institutional financing in India
- Classification of financial institutions in India
- Operations of all-India development financial institutions, investment institutions, specialised financial institutions and State level institutions
- A critical appraisal of the industrial financing institutions.

EVOLUTION OF INSTITUTIONAL FINANCING IN INDIA

In 1945 a detailed study was carried out by the Reserve Bank of India to explore the possibilities of both all-India and regional institutions of industrial finance. In its report, the Reserve Bank had made an elaborate proposal for setting up an all-India institution. The proposal took concrete shape with the establishment of the Industrial Finance Corporation of India (IFCI) in 1948. ***The IFCI was the first institution of its kind in India to be set up and experts are justified in their assertion that its establishment "marks the beginning of the era of development financing in India."*** The role assigned to it was that of a gap-filler which implied that it was not expected to compete with the existing channels of industrial finance. It was expected to provide medium and long-term credit to industrial concerns including co-operatives, only when they could not raise funds by taking recourse to capital issue method or normal banking accommodation. ***The establishment of the IFCI was followed by the setting up of financial institutions at the State level.*** The first State level development financial institution to be established was the Madras Industrial Investment Corporation. It was set up in 1940 and is now known as the Tamil Nadu Industrial Investment Corporation. Other State level development finance institutions (DFIs) were established in the early 1950s. They are known as the State Financial Corporations (SFCs). Like the IFCI, the State Financial Corporations were also expected to play the role of gap fillers. They, in fact, supplemented the work of the IFCI as they were required to finance small and medium-sized industrial units. Their orthodox approach in early years of their existence, however, proved to be a serious obstacle to providing capital to really deserving industrial enterprises.

Commenting on the failure of both the IFCI and SFCs, M.Y. Khan remarked, "Their policies were characterised by excessive caution; their procedures were dilatory, they concentrated on traditional industries and more emphasis was laid on security rather than on prospects. It was no wonder, therefore, that they failed to make any impact on the availability of long-term finance to industry and, consequently, could not justify the expectation of solving the problem of chronic shortage of industrial capital in India."[1]

In view of the early experiences of the working of the IFCI and the SFCs, the need for the establishment of some more dynamic institutions which could operate as true development agencies was felt. Hence, two other institutions, namely, the National Industrial Development Corporation (NIDC) and the Industrial Credit and Investment Corporation of India (ICICI) were created. The NIDC was established in 1954 with the objective of promoting industries which could not be easily developed otherwise, though they were considered vital for the growth of the economy. With this perspective the NIDC was not expected to function merely as a financial agency. The original role assigned to it was quite ambitious but, in practice, it soon got transformed into a financing agency restricting itself to modernisation and rehabilitation of cotton and jute textile industries. Later on, it was converted into a consultancy organisation and thus ceased to operate as a development finance institution (DFI).

The ICICI was established in 1955 as a development finance institution. Though sponsored by the World Bank, it was set up with the active co-operation of the Government of India. Its ownership, however, was entirely in the private sector. In its conception, from the very beginning, it has been an issuing-cum-lending institution. As a recipient of loans from the World Bank it has served as a channel for the World Bank's aid to industries in the private sector. ***The ICICI ceased to be a development finance institution after its merger into ICICI Bank with effect from March 30, 2002.***

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The Refinance Corporation for Industry (RCI) was set up in 1958 with the purpose of providing refinance to commercial banks against long- and medium-term loans granted by them. In 1962, the RCI was authorised to provide refinance to the State Financial Corporations also. Since the scope of the activities of the RCI was narrow, it was not fit to emerge as an apex development finance institution in this country. The government, therefore, created an entirely new institution, *viz.*, the ***Industrial Development Bank of India (IDBI)*** to act as an apex institution in the sphere of industrial finance. With the establishment of the IDBI in 1964 a major reorganisation was effected in the sphere of industrial finance. The IDBI was initially set up as a wholly owned subsidiary of the Reserve Bank of India. In February 1976, the IDBI was made an autonomous institution and its ownership passed on from the Reserve Bank to the Government of India. ***The role of the IDBI was conceived not merely as one of a financing agency. It was, in fact, expected even to co-ordinate the activities of the institutions engaged in financing, promoting or developing industry***. IDBI was converted into a bank on October 11, 2004.

CLASSIFICATION OF FINANCIAL INSTITUTIONS IN INDIA

Thanks to the initiatives taken by the government, a large number of other financial institutions have also come up in the post-Independence period. The wide variety of financial institutions existing in India can be broadly classified into all-India financial institutions, State level institutions and other institutions. The financial institutions within these groups can be further categorised according to their main activities/functions into:

1. All-India Development Finance Institutions (DFIs) — Industrial Finance Corporation of India Ltd. (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI), Industrial Credit and Investment Corporation of India Ltd. (ICICI Ltd.) has ceased to be a development bank after its merger with ICICI Bank with effect from March 30, 2002. IDBI was converted into a bank on October 11, 2004.

2. Specialised Financial Institutions — Export-Import Bank (EXIM Bank), IFCI Venture Capital Funds (IVCF, formerly RCTC) Ltd., ICICI Venture Ltd. (formerly TDICI Ltd.), Tourism Finance Corporation of India (TFCI) Ltd., and Infrastructure Development Finance Company (IDFC) Ltd.

3. Investment Institutions — Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), and General Insurance Corporation of India (GIC) and its four erstwhile subsidiaries.

4. Refinance Institutions — National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD).

5. State Level Institutions — State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

6. Other Financial Institutions — Some other financial institutions are Export Credit and Guarantee Corporation of India Ltd. (ECGC) and Deposit Insurance and Credit Guarantee Corporation (DICGC).

The all-India financial institutions have been fast losing ground in recent years. This situation has come about as a result of the distinction between development and commercial banking getting blurred, high cost of funds and asset-liability mismatches. With reforms in the financial sector, the facility of low cost funds under long-term operations funds, funds from bilateral and multilateral agencies and bond issues under statutory liquidity ratio is no more available. Now the financial institutions are raising funds at markets rates of interest. The Narasimham Committee-II had recommended that with the convergence of activities between banks and development financial institutions, the development financial institutions should, over a period of time, convert themselves into banks paving the way for only two forms of intermediaries, *viz.*, banking companies and non-banking financial institutions. The Reserve Bank of India had advised financial institutions to chart a path for their evolution into universal banks. The merger of ICICI with the ICICI Bank was approved by the Reserve Bank in April 2002. The ICICI had accounted for a substantial part of the sanctions and disbursements of all-India financial institutions. With its merger with ICICI Bank, the role of all-India financial institutions subsided further. Similarly, in order to pave the way for conversion into a universal bank, IDBI had approached the government to corporatise it by repealing the IDBI Act. Accordingly, the government announced the proposal for corporatising IDBI by introducing the necessary legislative changes.

In India, development finance institutions performed well till the turn of the century. Aggregate assistance sanctioned and disbursed by all the financial institutions increased considerably till 2000-01. In 2000-01 assistance sanctioned and disbursed by all the financial institutions stood at ₹ 1,21,352 crore and ₹ 76,139 crore respectively. However, assistance sanctioned and disbursed fell thereafter. For example, financial assistance sanctioned and disbursed by financial institutions was ₹ 58,733 crore and ₹ 46,029 crore respectively in 2007-08. The official explanation of

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the declining financial assistance from all the financial institutions considered together is ***"reduction in the number of project proposals seeking financial assistance, financial restructuring of asset portfolios by financial institutions, weak financial positions of IDBI and ICICI and spread of universal banking."***[2] However, because of substantial increase in financial assistance from LIC in 2008-09, the financial assistance sanctioned by these institutions rose to ₹ 1,05,228 crore and financial assistance disbursed to ₹ 94,270 crore in this year. Financial assistance sanctioned and disbursed stood at ₹ 1,54,373 crore and ₹ 1,28,214 crore respectively in 2017-18.

Let us now turn to a discussion of leading financial institutions. We have included ICICI and IDBI in our discussion because of the important role that they played in their lifetime in the historical development of institutional financing in this country.

ALL-INDIA DEVELOPMENT FINANCIAL INSTITUTIONS

Industrial Finance Corporation of India Ltd.

As stated earlier, the Industrial Finance Corporation of India (IFCI) was the first All-India Development Financial Institutions to be set up in the country. ***It was set up in 1948 with the object of providing medium and long-term credit to industry***. As pointed out earlier, its role was that of **a gap filler** as it was not expected to compete with the then prevailing channels of industrial finance. It was only meant to supplement their efforts. ***With effect from July 1, 1993, the IFCI has been converted into a public limited company and is now known as Industrial Finance Corporation of India Ltd.***

Functions of the IFCI. The Industrial Finance Corporation of India grants financial assistance in the following forms: (1) Granting loans or advances both in rupees and foreign currencies repayable within 25 years; (2) Guaranteeing rupee loans floated in the open market by industrial concerns; (3) Underwriting of shares and debentures of the industrial concerns; (4) Guaranteeing (*a*) deferred payments in respect of imports of machinery, (*b*) foreign currency loans raised from foreign institutions, and (*c*) rupee loans raised from scheduled banks or State co-operative banks by industrial concerns.

In the beginning, the IFCI was expected to extend financial assistance only to industrial concerns in the private and co-operative sectors. Later on, both public sector and joint sector projects were also made eligible for financial assistance from the IFCI. Financial assistance is available from the IFCI for new industrial projects as well as for expansion, renovation, modernisation or diversification of the existing ones. This may include the purchase of plant and machinery, construction of factory building and purchase of land for the factory. Normally, the IFCI does not provide finance for the repayment of existing liabilities. Its funds are also not available for raising working capital which includes the purchase of raw material.

Financial Resources of the IFCI. Financial resources of the IFCI are constituted of the following three components: *(i)* share capital *(ii)* bonds and debentures, and *(iii)* other borrowings. The paid-up capital of the IFCI was initially ₹ 5 crore. Since then it has been increased several times and as on March 31, 2018 stood at ₹ 1,921 crore. Industrial Development Bank of India, commercial banks, the LIC and the co-operative banks account for the share capital of the IFCI. The IFCI has also built-up sizeable reserves. Apart from the paid-up capital and reserves, the major financial resources of the IFCI are issue of bonds and debentures, borrowings from the government and the Industrial Development Bank of India, and foreign loans. The bonds and debentures are guaranteed by the Government of India in respect of repayment of principal and the payment of interest.

Lending Operations of the IFCI. The IFCI had started its lending operations on a modest scale in 1948, but over the years with greater accent on industrialisation, they grew both in scope and size. While in 1970-71, assistance sanctioned was of ₹ 32.2 crore, in 1995-96, it touched the level of ₹ 10,300 crore. However, since the latter half of 1990s assistance sanctioned by the IFCI steeply declined. In 2003-04 it was only ₹ 1,392 crore. Although IFCI provides assistance to all — the private sector, the co-operative sector and the public sector — it is the private sector that is the main recipient of its assistance. Financial assistance sanctioned and disbursed by IFCI in 2017-18 stood at ₹ 7,216 crore and ₹ 4,434 crore respectively.

The IFCI has set up Merchant Banking and Allied Services Department (MBAD) with head office in Delhi and a bureau in Mumbai. MBAD has taken up assignments for capital restructuring, merger and amalgamation, loan syndication with other financial institutions, and trusteeship assignments. It guides entrepreneurs in project formulation and raising resources for meeting project cost, etc.

Appraisal of IFCI's Performance. Opinions differ in respect of the IFCI's working over the past six-and-a-decades. Looking at the growth of the IFCI's capital and financial assistance sanctioned and disbursed its performance seems to be quite impressive. However, an in-depth study reveals certain flaws in its functioning and these have invited criticisms from different quarters. The important criticisms are as follows: (*i*) As pointed out by the

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Mahalanobis Committee long ago, the IFCI's lending operations have encouraged concentration of wealth and capital. Even now it is alleged that it pursues a discriminatory policy to the disadvantage of medium- and small-sized industrial units; (*ii*) For a considerable period of time, the IFCI did little to remove regional imbalances. It is difficult to justify why in the past industrial concerns in Maharashtra got as much assistance as the ones located in five backward States of Assam, Orissa, Kerala, Rajasthan and Madhya Pradesh taken together. However, lately IFCI has provided considerable assistance to units established in backward areas; (*iii*) In sanctioning assistance the IFCI has not always upheld the national priorities as stated in various plan documents; *(iv)* It has quite often offered assistance to undertakings which could easily raise resources from the capital market; and (*v*) The IFCI has failed to exercise necessary control over the defaulting borrowers. The borrowing concerns have not in some cases used the loans for the purposes for which they were sanctioned, and yet IFCI has not initiated any action against them.

The performance of the IFCI has been extremely unsatisfactory during recent years. In fact, for the financial year ended March 2002, IFCI incurred losses to the tune of ₹ 885 crore on an income of ₹ 2,249 crore. And in the same year, the interest income (₹ 1,976 crore) was actually less than the interest expense (₹ 2,384 crore) raising questions about the very fundamentals of the business.[3] Not only this, ***the share of non-performing assets (NPAs) in net loans as at end-March, 2005 was as high as 28.0 per cent for IFCI*** (though it improved to 9.1 per cent as at end-March 2006). The capital to risk weighted asset ratio (CRAR) was negative at –27.9 per cent as at end-March 2006 (though it improved considerably to 14.0 per cent as at end-March 2007).[4] In year ending March 2004, the operating profits to average working funds ratio fell to –1.9 per cent indicating that IFCI was suffering operating losses. However, things improved later and the ratio increased to 6.7 per cent as at end-March 2006 and further to 10.2 per cent as at end-March 2007.[5] All these facts taken together reveal the poor health of IFCI. Moreover, the steadily declining sanctions and disbursements of IFCI from 1996-97 onwards indicate its growing irrelevance in the new context.

The Industrial Credit and Investment Corporation of India Ltd.

The Industrial Credit and Investment Corporation of India (ICICI) was the second all-India development financial institution to be established in the country. ***It was set up in January 1955 and it commenced business in March of the same year.*** The ICICI differed from two other all-India development financial institutions, *viz.,* the IFCI and IDBI in respect of ownership, management and lending operations. Unlike the IFCI and the IDBI which were public sector development financial institutions, the ICICI was a private sector development financial institution. Its distinguishing feature was that it provided underwriting facilities which are generally neglected by the other institutions. The ICICI ceased to be a development finance institution on account of its merger into ICICI Bank in April 2002.

The ICICI provided assistance in various forms, the important ones being: (1) long- or medium-term loans or equity participation; (2) guaranteeing loans from other private investment sources; (3) subscription to ordinary or preference capital and underwriting of new issues or securities; and (4) rendering consultancy service to Indian industry in the form of managerial and technical advice.

Lending Operations of ICICI. In terms of sheer amount of financial assistance provided by the ICICI, its performance was quite impressive. From ₹ 43.9 crore in 1970-71 and ₹ 3,744 crore in 1990-91, the assistance sanctioned by the ICICI rose to ₹ 55,815 crore in 2000-01. However, assistance sanctioned declined to ₹ 36,229 crore in 2001-02. The ICICI provided financial assistance in the form of (*i*) rupee loans including guarantees; (*ii*) foreign currency loans; (*iii*) underwriting of shares and debentures; (*iv*) direct subscription to shares and debentures; and (*v*) financial services (in the form of deferred credit, leasing, instalment sale and asset credit).

The ICICI was originally set up to provide finance to industrial concerns in the private sector, and accordingly, they accounted for the bulk of the loans sanctioned by this institution. The scope of its operations was later enlarged by including the projects in the joint, public and co-operative sectors. As far as industry-wise assistance is concerned, the major recipients of the financial assistance from the ICICI have been non-traditional growth-oriented industries such as chemicals, petrochemicals, heavy engineering and metal products.

In 1983, ICICI commenced leasing operations. It provided leasing assistance for computerisation, modernisation/replacement schemes, equipment for energy conservation, export orientation, pollution control, balancing and expansion. It also joined the consortium of the IDBI, the IFCI and other financial institutions for providing 'loans on soft terms' to a number of industries for modernisation.

Appraisal of ICICI's Performance. The ICICI in 47 years of its existence played an important role in providing financial assistance to industrial enterprises in the private sector. Its pioneer work as the underwriting institution in this country has been widely acclaimed. The provision of foreign currency loans is another area where the ICICI

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distinguished itself. A large number of growth-oriented industries such as chemicals, petrochemicals, heavy engineering and metal products industries are primarily interested in such foreign currency loans for importing capital equipment and it is here that ICICI gave them a helping hand. The ICICI was, however, rightly criticised for assisting mainly the large units. Moreover, it did little to promote industrial development in the less developed regions. Its policy of financing the projects in a few relatively industrially advanced States had, in fact, accentuated regional disparities. However, because of this criticism of its functioning, ICICI increased its assistance to backward areas in later years of its existence. The ICICI also participated in setting up Technical Consultancy Organisations in a number of backward States.

In 2001-02, the ICICI was the top dispenser of development finance. In fact, for five years since 1997-98, ICICI sanctioned and disbursed more financial assistance than even IDBI which was set up as the leading public sector development finance institution. The ICICI nonetheless quietly shed its DFI status and merged with its offspring, ICICI bank in 2002.

The Industrial Development Bank of India

Prior to the establishment of the Industrial Development Bank of India (IDBI), the country had a number of special industrial financing institutions. They had done commendable work in the field of industrial finance, though in terms of range and magnitude they could not adequately meet the demands of the industry. Furthermore, there was a major lacuna in the system. There was no apex organisation to co-ordinate the functions of various industrial financing institutions. V.V. Bhatt rightly stated that the country needed a central development banking institution for providing "dynamic leadership in the task of promoting a widely diffused and diversified and yet viable process of industralisation."[6] It was under these circumstances that IDBI was set up in July 1964. ***The IDBI was initially set up as a wholly owned subsidiary of the Reserve Bank of India. In February 1976 the IDBI was made an autonomous institution and its ownership passed on from the Reserve Bank of India to the Government of India.***

The IDBI was designated as the apex organisation in the field of development financing. It not only had organisational links with other development banks but it also rendered some such services to them which only an apex organisation is expected to perform. In the first place, it provided refinance against loans granted to industrial concerns by other development finance institutions like the IFCI, the SFCs and so on and rediscounted their machinery bills. Secondly, it subscribed to the share capital and bond issues of the IFCI, the SFCs and the IIBI (Industrial Investment Bank of India). Apart from these linkages, the IDBI played the role of a coordinator at all-India level. For this purpose, a machinery was evolved and regular meetings of the Heads of various financial institutions were held under its leadership. Thus, the IDBI enjoyed a unique position in India's development financing system. It occupied the same place in the field of development financing as is occupied by the RBI in the field of commercial banking. However, ***IDBI was converted into a Bank in October 2004.***

Financial Resources of IDBI. The operations of the IDBI grew over the years and so did its resources. The main sources of its funds were share capital, reserves, bonds and debenture issues, deposits from companies and Certificates of Deposits, and borrowings from the Reserve Bank of India and the Government of India. The total resources of IDBI amounted to ₹ 63,846 crore in 2004. Capital issued and paid up amounted to ₹ 653 crore. Bonds and debentures were the most important source of IDBI resources. Their share was ₹ 43,750 crore (68.5) per cent. The share of reserves and reserve funds was ₹ 5,182 crore (8.1) per cent. Borrowings from RBI, government and other sources stood at ₹ 8,499 crore (13.3 per cent).

Cumulative Assistance by the IDBI. The IDBI has been the leading development finance institution in India. Its progress had been spectacular till 2000-01. Thereafter, like other development financing institutions, the IDBI also suffered a setback. The cumulative assistance sanctioned by IDBI till the end of March 2004 aggregated ₹ 2,23,524 crore. Considering the underdeveloped nature of the capital market and the difficulties which a large number of industrial firms encounter in raising funds from the market, this quantum of assistance is not small. In fact, it is almost equal to the amount of financial assistance provided by all other special industrial financing institutions taken together. The amount of assistance disbursed by IDBI till the end of March 2004, from the date of establishment, totalled ₹ 1,75,572 crore.

Composition of Financial Assistance. The statute pertaining to the IDBI enabled it to have considerable flexibility in its operations. It, therefore, could provide financial assistance to all kinds of big, medium and small enterprises. In respect of the size of loans, there was virtually no restrictions on it. Moreover, it was completely free to use its own discretion in respect of the security to be obtained against the loan sanctioned. Its assistance assumed the following forms:

1. Direct financial assistance to industrial enterprises. The IDBI provided direct financial assistance to industrial concerns in the form of loans, underwriting and direct subscription to shares and debentures and guarantees.

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The policy framework of the IDBI in respect of direct financing was decided by its apex position. It, therefore, generally avoided competing with other special industrial financing institutions. It, in fact, acted as the lender of the last resort. The IDBI's direct assistance to industrial enterprises in the entire period of its existence accounted for about one-third of its total assistance. Loans as a form of direct finance constituted the major part of the IDBI's financial assistance to the industry.

2. Indirect financial assistance to industries. A major part of the IDBI's assistance was routed through some other financial institutions including the State Financial Corporations, State Industrial Development Corporations and Commercial Banks. This form of assistance is generally characterised as indirect financial assistance. The IDBI's indirect assistance can be broadly classified into four categories: (*i*) refinance of industrial loans, (*ii*) rediscounting of bills, (*iii*) subscription to shares and bonds of financial institutions and (*iv*) seed capital assistance.

3. Assistance to backward areas. The IDBI initiated certain financial and non-financial measures to encourage industries in backward areas. Financial measures were mainly of three types: (*a*) direct financial assistance in the form of loans at concessional rates, longer initial grace period, etc.; (*b*) concessional refinance assistance to projects in backward areas; and (*c*) special concessions to projects in North-Eastern area under the bill rediscounting scheme. Non-financial measures aimed at helping potential entrepreneurs in identifying and formulating viable projects, technical assistance etc.

Industry-wise analysis of IDBI's financial assistance reveals that core and other manufacturing sectors accounted for bulk of the assistance sanctioned and disbursed. Core sector includes industries such as iron and steel, oil exploration and refining, cement and fertiliser. Other major industries that received large sanctions are: chemicals and chemical products, textiles, electronic and electrical products food manufacturing and artificial fibres.

Promotional Functions of the IDBI. Apart from providing financial assistance to industry, the IDBI performed certain promotional functions as well. These included provision of training in project evaluation and development of entrepreneurship. A special scheme was initiated for "no industries districts." Under this scheme, IDBI carried out surveys to study the industrial potential of no industry districts. The programme was to arrange training for potential entrepreneurs in these districts besides giving financial, technical and administrative assistance to selected projects. It also operated a Technical Consultancy Organisation (TCO). Besides doing feasibility studies, project appraisals, industrial and market potential surveys, etc., TCO also made considerable progress in training new entrepreneurs. The IDBI also supported a number of inter-institutional groups which provided a forum for discussions on industrial development programmes.

Critical Appraisal. The IDBI was set up five decades ago to function as an apex institution in the field of development finance. Judged by its assistance measured in quantitative terms, the performance of the IDBI looks quite impressive. Over the years not only the amount but also the range and pattern of assistance grew. This is a significant contribution when we view it in the light of the fact that capital market in the country is still not very much developed. However, without undermining the importance of the contributions made by the IDBI, it must be stated that it failed to develop itself as a true development bank. Its accent on providing loans and treating underwriting of shares and debentures of industrial concerns as a secondary activity was not very appropriate. Secondly, in spite of all its pretensions in providing assistance to projects in backward areas and also to the small-scale sector, the largest beneficiaries of the assistance provided by the IDBI were big industrial concerns. Thus, the distributional consequences of its working were in all probability, not very healthy. Finally, the IDBI mainly concentrated on providing financial assistance. The promotional and consultancy work was not assigned the same importance as financial assistance.

Small Industries Development Bank of India

With a view to ensuring larger flow of financial and non-financial assistance to the small-scale sector, the Government of India announced in the Budget for 1988-89, its decision to establish Small Industries Development Bank of India (SIDBI) as a subsidiary of IDBI. The SIDBI Act was passed by the Parliament in October 1989 and the Bank commenced its operations from April 2, 1990. To equip SIDBI to play its apex role in SSI credit provision more effectively, the Union Budget 1998-99 proposed the delinking of SIDBI from IDBI and transferring of IDBI shareholding in SFCs to SIDBI.

Financial Resources of SIDBI. The SIDBI commenced its operations with an initial paid-up capital of ₹ 250 crore and by taking over the outstanding portfolio of IDBI relating to small-scale sector held under Small Industries Development Fund as on March 31, 1990 amounting to ₹ 4,200 crore. The paid-up capital was subsequently raised to ₹ 532 crore. The financial resources of SIDBI aggregated ₹ 1,08,869 crore at end-March 2018. Of these, borrowings from Government of India and other sources contributed ₹ 34,142 crore (*i.e.*, 28 per cent). Bonds and debentures contributed ₹ 16,549 crore (13 per cent).

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Financial Assistance by SIDBI. With a view to ensuring larger flow of assistance to the small-scale units, the immediate thrust of SIDBI was on: (*i*) initiating steps for technological upgradation and modernisation of existing units; (*ii*) expanding the channels for marketing the products of the small-scale sector; and (*iii*) promotion of employment-oriented industries especially in semi-urban areas to create more employment opportunities and thereby checking migration of population to urban areas. SIDBI provides assistance to the small-scale units through the existing credit delivery system comprising State Financial Corporations, State Industrial Development Corporations, Commercial Banks, Co-operative Banks and Regional Rural Banks. The major activities of SIDBI are: (*i*) refinance of loans and advances; (*ii*) discounting and rediscounting of bills; (*iii*) extension of seed capital/soft loans; (*iv*) granting direct assistance and refinancing of loans; (*v*) providing services like factoring, leasing etc.; and (*vi*) extending financial support to State Small Industries Development Corporations. During 2017-18, assistance sanctioned by SIDBI stood at ₹ 59,465 crore while assistance disbursed was ₹ 59,059 crore.

The Industrial Investment Bank of India

There are a number of industries having sick industrial units. These units possess obsolescent machinery and poor management. The economic position of some units has deteriorated because the managers of these units have paid more attention to distribution of dividends rather than reinvestment (or ploughing back) of profits. The government did not want these units to shut down because this would lead to retrenchment of employees and large-scale unemployment of industrial workers. Accordingly, it established the Industrial Reconstruction Corporation of India (IRCI) in 1971 to provide financial assistance to industrially sick units and, if necessary, to provide managerial and technical assistance as well.

By a notification issued on March 20, 1985, the government converted the IRCI (which was a company registered under the Companies Act) into a statutory corporation to be called the Industrial Reconstruction Bank of India (IRBI) with a view to overcoming the inherent difficulties which had been faced by the IRCI in its efforts to rehabilitate sick industrial units. IRBI was reconstituted into a new full-fledged all-purpose development financial institution under the Company Act, 1956 in March 1997 with adequate operational flexibility and functional autonomy. The entire assets and liabilities of IRBI have been transferred to this new company which is known as Industrial Investment Bank of India (IIBI).

The cumulative assistance sanctioned and disbursed by IIBI as at end-March 2004 was ₹ 14,050 crore and ₹ 13,396 crore respectively. Assistance sanctioned by IIBI in 2003-04 was ₹ 2,412 crore while assistance disbursed was ₹ 2,252 crore. The operations of IIBI in subsequent years have been negligible.

The performance of IIBI is worrisome. The share of net NPAs in net loans as at end-March 2006 was as high as 13.1 per cent while its capital to risk-weighted asset ratio (CRAR) was negative and stood at –64.2 per cent. Moreover, in year ending March 2005, the operating profits to average working funds ratio fell to –7.6 per cent indicating that IIBI was suffering operating losses.[7] In fact, because of its very poor financial position, IIBI is in the process of voluntary winding up.

INVESTMENT INSTITUTIONS

The Unit Trust of India

Unit trusts are quite popular in the West and have made rapid progress over the last few decades as they possess certain advantages over other forms of intermediation. The notable advantages of the unit trusts are: (1) diversified portfolio or pooling of risks; (2) professional management; and (3) high degree of liquidity. A small investor on his own cannot avert risk if he directly makes investment in the shares and debentures of companies. With small resources to invest he cannot have diversified portfolio. The unit trusts are open-end investment trusts. The term 'open end' implies that these investment trusts can sell their units continuously in order to raise additional capital. They also redeem their shares (repurchase their units) for enabling investors to liquidate their investment. This redemption feature of units ensures high degree of liquidity.

The Unit Trust of India was set up on November 26, 1963 after Parliament had passed the Unit Trust Act. The sales of units were started on July 1, 1964.

The flagship scheme of the UTI was the unit scheme 64, popularly known as US-64, which was launched in 1964. It was the first scheme in India to channel public savings into non-deposit instruments like equity and corporate debt. US-64 was successful in building up the largest customer base in the world. Over the years the UTI almost single-handedly built the Indian mutual fund industry.

However, in the unwarranted euphoria following the reforms of 1991 and the 'blown up' stock market expectations that accompanied it, ***the UTI started investing more and more into equities turning the assured income oriented US-64 scheme into a high-risk equity oriented scheme.***

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This would be clear from the fact that the equity-debt ratio in US-64 changed from 28:72 in 1991-92 to 64:36 in 1997-98. The stock market crash spelt doom for the scheme. Although UTI did not declare the NAV (Net Asset Value) of US-64 and kept it a closely guarded secret, estimates show that the NAV turned less than ₹ 10. In December 1998, reserves under the scheme were reported negative. There was a widespread panic and people started redeeming their units in large numbers.

In a bid to stem the rot and save US-64 from disaster, the Government of India appointed an Expert Committee under the Chairmanship of Deepak Parekh to undertake a comprehensive review of the functioning of UTI and make recommendations to restore investor confidence. The Committee made a number of recommendations, which included suggestion for converting US-64 into a NAV driven scheme over a three year period, fiscal incentives to investors in US-64 scheme, revamping of dividend distribution policy etc. Accordingly, the Union Budget, 1999-2000 announced a number of concessions. Moreover, in order to bail out US-64, a corpus of ₹ 3,000 crore was provided to the UTI.

In July 2001, that is, in less than three years since the US-64 fiasco of 1998 the scheme was back to square one with positive returns turning negative once again due to heavy investments in highly volatile IT stocks and dismal state of the equity market. As a result, UTI had to slash down the dividend rate for the year 2000-01 and suspend sales and repurchases of US-64 for a period of six months from July 2001 to December 2001. This created a crisis of confidence. Net resource mobilisation by UTI which was ₹ 4,548 crore in 1999-2000 fell to only ₹ 322 crore in 2000-01 and turned negative at –₹ 7,248 crore in 2001-02.[8]

To tackle the problems facing the UTI, the Cabinet Committee on Economic Affairs (CCEA) in its meeting held on August 31, 2002, granted its approval to a UTI reform package. This package envisaged the splitting up of UTI into two parts: UTI-I and UTI-II. The UTI-I comprising US-64 for which assured repurchase prices were announced and all other assured returns schemes (21 schemes plus Special Unit Scheme 1999), was to be managed by a government appointed administrator with the government meeting all obligations annually to cover any deficit. UTI-II comprised all NAV based schemes and was to be managed by a professional Chairman and Board of Trustees and was to be disinvested in the future. Since UTI-II was not to be subject to any redemption guarantees or assured return schemes, the transactions were to be based on the market perception of the fund managers and the management.

Insurance Organisations

Life Insurance Corporation of India. Life Insurance Corporation of India (LIC) was set up in 1956 when the life insurance business was nationalised. It took over the assets and liabilities of 245 private insurers engaged in the transaction of life insurance business in India. LIC with its central office in Mumbai and seven zonal offices at Mumbai, Kolkata, Delhi, Chennai, Hyderabad, Kanpur and Bhopal operates through 100 divisional offices in important cities and 2,048 branch offices. With 7.92 lakh agents, it has the largest field organisation in the country. In 2017-18, LIC sanctioned assistance worth ₹ 86,184 crore while disbursement was ₹ 63,793 crore. In fact, LIC's share in total assistance sanctioned by all financial institutions in 2017-18 was as high as 56 per cent while its share in total assistance disbursed by all financial institutions was 50 per cent.[9] Thus, LIC has emerged as the most important financial institution. Assistance by LIC has been provided in the following forms: (1) term loans; (2) underwriting and direct subscriptions in the form of (*i*) equity and preference shares and (*ii*) debentures; and (3) resource support to financial institutions. Because of LIC's efforts to earn sustained and guaranteed income for its policyholders, it has preferred investment in debentures over equity shares.

General Insurance Corporation of India. The general insurance industry was nationalised in 1971 and a government company known as General Insurance Corporation of India (GIC) was formed by the Central government in November 1972. The erstwhile 107 Indian and foreign insurers who were operating in the country prior to nationalisation, were grouped into four operating companies, namely (*i*) National Insurance Company Ltd.; (*ii*) New India Assurance Ltd.; (*iii*) Oriental Insurance Company Ltd.; and (*iv*) United India Insurance Company Ltd. These were the four subsidiaries of GIC operating all over the country competing with one another and underwriting various classes of general insurance business. Pursuant to the enactment of General Insurance Business (Nationalisation) Amendment Act, 2002, GIC has now been delinked from its four subsidiaries. GIC would undertake only refinance business and cease to carry out general insurance business. The four 'acquiring insurance companies' (*i.e.*, its four former subsidiaries) would carry on general insurance business. Financial assistance sanctioned and disbursed by GIC in 2016-17 both stood at ₹ 25 crore.

SPECIALISED FINANCIAL INSTITUTIONS

With the rapid expansion of economic activity over the years, some specialised financial institutions have been

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set up. ICICI Venture Fund, formerly known as Technology Development and Information Company of India Ltd. (TDICI) was set up in 1988. It was renamed ICICI Venture Fund in October 1998. ICICI Venture Fund is a technology venture finance company that grants project finance to new technology ventures. It operates through venture capital funds (VECAUS I and VECAUS II schemes).

IFCI Venture Capital Funds (IVCF) — formerly known as RCTC Ltd. — provides both risk capital and technology finance under one roof to innovative entrepreneurs and technocrats for their technology-oriented ventures. Tourism Finance Corporation of India Ltd. (TFCI) commenced its business from February 1, 1989. TFCI caters to the financial requirement of the tourism industry, allied activities, facilities and services. Export-Import Bank of India (EXIM Bank) was established for financing, facilitating and promoting foreign trade in India. Another specialised financial institution is the Infrastructure Development Finance Corporation (IDFC).

STATE LEVEL INSTITUTIONS

All the financial institutions discussed so far operate at the national (all-India) level. Thus, they fall under the broad category 'All-India Financial Institutions.' At the State level, the two institutions that need specific discussion are the State Financial Corporations (SFCs) and the State Industrial Development Corporations (SIDCs).

State Financial Corporations

The Industrial Finance Corporation of India was set up to offer financial assistance to only large- and medium-sized undertakings. Therefore, need for separate State level development banks which could cater to financial needs of small- and medium-sized industrial concerns was rightly felt. Accordingly, the State Financial Corporation Act was passed by Parliament on September 28, 1951, as an enabling measure, under which State Financial Corporations (SFCs) could be set up. The first SFC was set up in Punjab in 1953. Subsequently in other States too, SFCs were set up. At present there are, in all 17 SFCs in the country. Normally, operations of SFCs are confined to their respective States. However, in some cases they extend to neighbouring States or Union Territories.

Functions and Types of Assistance. The SFCs have been set up to extend long-term finance to small- and medium-scale industrial undertakings organised as public or private companies, co-operatives, partnerships or proprietary concerns. The SFCs render assistance in the following forms: (1) Grant of loans and advances to industrial concerns for periods not exceeding 20 years; (2) Subscription to debentures repayable within a period of 20 years; (3) Guarantee of loans raised in the market or from scheduled or co-operative banks by the industrial concerns and repayable within 20 years; (4) Guarantee of deferred payments for purchase of plant, machinery, etc., within India; (5) Underwriting the issue of stocks, shares, bonds and debentures by industrial undertakings.

Apart from independently rendering financial assistance in the above-mentioned forms, the SFCs can also act as the agent of the Central and State governments, the Industrial Development Bank of India, the Industrial Finance Corporation of India or some other special industrial financing institution in respect of grant of loans or advances or subscription to bonds or debentures.

Financial Resources of SFCs. The resources of SFCs consist of (*a*) capital and reserves, (*b*) bond and debenture issue, (*c*) borrowings from the Reserve Bank of India, IDBI, SIDBI and the State governments, and (*d*) fixed deposits. As far as SFC bonds and debentures are concerned, they are mostly subscribed by commercial banks, the Life Insurance Corporation of India and other financial institutions. They are presently an important source of the resources of the SFCs and account for about one-third of them.

The SFCs also borrow from the Reserve Bank, the State governments, IDBI and SIDBI. The borrowings of the SFCs including the bond issues at any time should not exceed 10 times of their paid-up capital and reserves. During recent years, refinance from SIDBI has become an important source of funds for the SFCs.

Lending Operations of SFCs. The SFCs had started their operations on a modest scale and their lending was rather small in the early years of their existence. So much so that until March 1975, their cumulative loan sanctions aggregated only ₹ 437 crore. Their loans and advances picked up thereafter in a big way. The cumulative assistance sanctioned and disbursed by the SFCs upto 2003-04 stood at ₹ 41,089 crore and ₹ 33,344 crore respectively. In 2003-04, the total assistance sanctioned and disbursed by 18 SFCs stood at ₹ 1,134 crore and ₹ 857 crore respectively (data for later period are not available).

The SFCs were established to provide financial assistance to small and medium enterprises. Since the concept of small unit has changed over the years, it is somewhat difficult to determine quantitatively how much financial assistance has been provided to small enterprises. But there is enough evidence to suggest that in the early years of their existence most of the SFCs preferred assistance to medium enterprises. In 1966 a beginning of the change in their approach was seen, when they decided to provide a large amount of their loans to small enterprises. Now there is a

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clear shift in their lending policies in favour of small enterprises.

An important aspect of the SFCs' lending policy is assistance to industrial enterprises located in backward areas. The SFCs have worked out a scheme of concessional financial assistance to industrial units located in backward areas with the purpose of inducing industrial activity in these regions. In terms of this scheme, industrial concerns in backward regions get soft loans at concessional rates, lower margins, reduced service charges, and so on. The impact of these measures is now visible as industries are now being set up at places where none would have otherwise taken any initiative.

Critical Appraisal of SFCs. The Working Group appointed by the Reserve Bank of India to look into the functioning of the SFCs found that the performance of the various State Financial Corporations was not very satisfactory. The SFCs have failed to meet the demands of medium and small industries adequately. Apart from the soft loans which they now sanction, on all other loans their rates of interest are high and terms and conditions stringent. ***In recent years a disquieting feature of their operations has come to the limelight. The overdues position has deteriorated considerably. The increasing overdues, which are largely on account of delays in implementation of projects and industrial sickness, have considerably cut into the resources available to SFCs for recycling.***

State Industrial Development Corporations

To accelerate the pace of industrial development in their States, many State Governments have set up State Industrial Development Corporations (SIDCs). Andhra Pradesh and Bihar were the first to set up SIDCs in 1960 followed by other States. Their number slowly grew to 28. A common feature of the SIDCs is that they are wholly owned by the respective State Governments. They undertake a wide range of functions, the important ones being: (*a*) grant of financial assistance; (*b*) provision of industrial sheds/plots; (*c*) promotion and management of industrial concerns; (*d*) promotional activities such as identification of project ideas, selection and training of entrepreneurs, provision of technical assistance during project implementation etc. and (*e*) providing risk capital to entrepreneurs by way of equity participation and seed capital assistance. As far as financial assistance is concerned, SIDCs provide assistance in the form of direct investment loans, extension of guarantee for loans and deferred payment, underwriting and subscription to the issue of shares, bonds and debentures. Financial assistance sanctioned and disbursed by the 28 SIDCs during the year 2002-03 was ₹ 924 crore and ₹ 1,250 crore, respectively (data for later period are not available).

A CRITICAL APPRAISAL OF THE INDUSTRIAL FINANCING INSTITUTIONS

While examining the importance of institutions engaged in providing finance to industry, it is frequent to talk of their quantitative and qualitative roles. From the quantitative point of view, the contribution of the financial institutions in industrial finance seems quite impressive. As far as the qualitative aspect is concerned, the financial institutions provide assistance to new enterprises, small and medium firms and industries established in backward areas. The objectives of following this policy are to induce widespread industrial development and reduce regional disparities. However, the financial institutions have granted a major part of their assistance to large industrial houses. Similarly, instead of granting more assistance to industries established in backward regions, financial institutions have contributed more to industries established in developed States. This would be clear from the fact that the three advanced industrial States of Maharashtra, Gujarat and Tamil Nadu together accounted for 45.7 per cent of the total assistance sanctioned by all-India financial institutions upto end-March 2003. Even when steps were taken to ensure more assistance to industries established in backward areas, the financial institutions pursued a policy of granting more assistance to backward areas of developed States *vis-à-vis* backward areas of less developed States.

Development financing institutions have been facing serious difficulties for the last few years. ***On the one hand, the burden of non-performing assets has been increasing while, on the other hand, the cost of raising funds has been rising. As a result, their profitability has fallen steeply.*** As mentioned earlier, the CRAR of IFCI was –27.9 per cent as at end-March 2006. The non-performing assets of some financial institutions have risen to more than 30 per cent of net assets which is very high. As far as the cost of raising funds is concerned, it is around 11 per cent for financial institutions as against only 8.5 per cent for banks. Because of the lacklustre performance of these institutions, they are also finding it difficult to raise resources from the capital market.

After carefully examining the role of development finance in India over the period of first five decades, we can say that both all-India and State level development finance institutions (DFIs) have played catalytic role in promoting industrial development. G.N. Bajpai, after taking note of sanctions and disbursements over the five decades period, and the fact that seventy-eight per cent of their sanctions have been made for private sector units asserts,

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"The DFIs have spurred balanced industrialisation and economic growth in the country over the past half century and have substantially fulfilled their initial mandate."[10]

However, in the economic reforms period (*i.e.*, the period since 1991), DFIs have been passing through difficult times as they are required to compete with non-banking finance companies (NBFCs) and commercial banks. The latter have an advantage over DFIs in terms of their geographical network, infrastructure, client base and flexibility in operation. While previously the DFIs used to obtain funds at concessional rates from the government and the Reserve Bank of India, they are now required to raise funds at market-related interest rates. However, as correctly pointed out by a working group of RBI recently, ***any model of DFIs that raises long-term resources at market rates of interest and extends project finance for long periods is unlikely to succeed.*** Because of their lacklustre performance, ***DFIs are also finding it difficult to raise resources from the capital market.*** As far as the corporate sector is concerned, following capital market reforms, it finds it easier to raise resources from this market rather than depend on DFIs. The government has also simplified norms for FDI (Foreign Direct Investment). The entry of venture capitalists, both domestic and foreign, has increased availability of risk capital to new generation entrepreneurs. Thus, with more private sector funds becoming available, the demand for funds from DFIs is falling. In brief, ***in the new economic environment that has emerged in the post-reform period, the DFIs seem to be losing their relevance.*** While some like ICICI and IDBI converted themselves into banks, some others like IIBI are closing down their operations. The DFIs that remain are fighting a losing battle.

G.N. Bajpai is of the view that DFIs can remain relevant even in the changed context but they will have to adopt a different approach. In his words, "Development Finance Institutions (DFIs) could consider adopting a three dimensional approach to remain relevant in the changed context. First, while the relevance of specialised DFIs such as NABARD and EXIM Bank, addressing a segmented need has not yet declined despite competition from the securities market and commercial banks, they need to focus on competence building and efficiency creation in their operations. Second, the business community need to be made to accept that development cannot remain the responsibility of government alone. Third, the most important is that they need to invest heavily in human capital so that they can transform themselves to suit the changing environment."[11]

NOTES

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3. "IFCI: The Noose Tightens", *Businessworld*, November 11, 2002, p. 44.
4. Reserve Bank of India, *Report on Trend and Progress of Banking in India* 2006-07 (Mumbai, 2007), Table V.10, p. 170 and Table V.12, p. 171.
5. *Ibid.*, Table V. 9, p. 170.
6. V.V. Bhatt, "A Decade of Performance of Industrial Development Bank of India", *Commerce* (Annual Number, 1974), p. 151.
7. In year ending March 2006, this ratio improved somewhat and stood at −1.4 per cent. However, it continued to be negative. Reserve Bank, *Report on Trend and Progress of Banking in India* 2006-07, *op. cit.*, Table V.9, p. 170.
8. Reserve Bank of India, *Report on Currency and Finance* 2001-02 (Mumbai, 2003), Table 6.25, p. VI-25.
9. Calculated from Reserve Bank of India, *Handbook of Statistics on the Indian Economy* 2016-17 (Mumbai, 2017), Table 82, pp. 143-5.
10. G.N. Bajpai, "Development Financing in a Changing Environment", *Economic and Political Weekly*, May 29, 2004, p. 2213.
11. *Ibid.*, p. 2212.

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53 Chapter

INDIA'S FISCAL POLICY

Fiscal policy is the use of government revenue collection (namely taxes) and expenditure (spending) to influence the economy. In a system of indicative planning, reliance on fiscal policy as an instrument of development is considerable. The Planning Commission had stated in the Seventh Five Year Plan, "Through it (fiscal policy), the Government creates and sustains the public economy consisting of the provision of public services and public investment; at the same time it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability."[1] ***Thus, fiscal policy has a multidimensional role. It particularly aims at improving the growth performance of the economy and ensuring social justice to the people. However, when fiscal policy is not used discreetly, it is likely to create a fiscal mess as it has happened in this country. A fiscal imbalance requires immediate corrective measures because a large fiscal deficit is non-sustainable.*** In the 1990s, world over it became fashionable to argue that legal restraints on government fiscal behaviour are necessary to prevent it from pursuing an irresponsible fiscal policy.

This chapter while discussing India's fiscal policy will address the following issues:

- Objectives of fiscal policy in India
- Fiscal imbalance and deficit finance
- Fiscal imbalance and the new fiscal approach
- Fiscal Responsibility and Budget Management Act.

OBJECTIVES OF FISCAL POLICY IN INDIA

Fiscal policy in India always had two major objectives, namely, ***improving the growth performance of the economy and ensuring social justice to the people.***

Growth Performance of the Economy

Fiscal policy influences growth performance of an economy mainly in two ways. In the first place, it affects growth by influencing the mobilisation of resources for development. Secondly, it exercises its influence by improving the efficiency of resource allocation.

1. Fiscal policy and resource mobilisation. India has done well in terms of tax effort. In 1950-51 when the planning process was initiated the tax-GDP ratio was as low as 6.3 per cent. Since then, it rose steadily for four decades and stood at 15.8 per cent in 1991-92. During the liberalisation phase of 1990s the tax-GDP ratio declined to 13.3 per cent in 1998-99 due to sharp reduction in tax rate. However, tax-GDP ratio rose again in later years and stood at 18.0 per cent in 2017-18. For a poor country like India, which started its development effort with a very low per capita income and has recorded an extremely modest rate of growth for a considerable period of planning, this record in mobilising tax revenue is not bad by any standard. In India, all the major direct taxes, such as personal income tax and corporation tax have recorded buoyancy greater than unity. However, in recent years, buoyancy of Union excise duty and customs duty has been low. Obviously this has not enabled as much mobilisation of resources through taxation as one would normally expect in the conditions prevailing in India. For example, there are many tax exemptions and concessions, agricultural incomes are out of the tax net, and there is a vast black economy.

Apart from tax revenue ***other important aspects of resource mobilisation are generation of non-tax revenues, restricting of current government expenditure and raising of surpluses of public sector enterprises. Each of these need careful analysis for assessing the government's effort in respect of resource mobilisation.*** However, for want of space, we shall focus on trends in overall public savings which can be justifiably considered as an appropriate index of resource mobilisation effort.

Since the Fourth Five Year Plan, the Planning Commission stated explicitly laying down targets for public savings rate for the terminal year of the respective Five Year Plan. On comparing the actual rates with these targeted rates, one is inevitably led to the conclusion that public savings performance has fallen markedly below planned levels in the past three decades. In 1980-81, the rate of public savings relative to GDP was 4.0 per cent which in any case was very low.

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Over the period 1998-99 to 2002-03, the rate of public savings relative to GDP was negative. Though it turned positive thereafter, it was only 1.3 per cent of GDP in 2003-04 and 1.2 per cent of GDP in 2011-12 (according to the new series with base year 2011-12, the rate of public savings was 1.5 per cent of GDP in 2011-12 and 1.3 per cent of GDP in 2015-16). The unsatisfactory performance of public savings is attributable to both weakness in mobilising revenues and a rapid growth in government expenditures. Another factor which explains the lacklustre public savings performance is failure of public sector enterprises to generate adequate surpluses. At the Central level, the ratio of PAT (profit after tax) to capital employed was below 5 per cent in a number of years. At the State level, the performance of the public sector enterprises is far more disappointing. Both the State Electricity Boards and the State Road Transport Undertakings have been incurring heavy losses for quite some time.

2. Fiscal policy and allocational efficiency. Fiscal Policy also influences growth performance of an economy through its effects on the allocation of resources. ***An efficient and rational allocation of resources will obviously be helpful in raising the rate of economic growth.*** Therefore, if fiscal policy favourably affects the efficiency of resource allocation, then in the process, growth performance of the economy is bound to improve. An indifferent fiscal policy adversely affecting the efficiency of resource allocation on the contrary retards the productive activity and thereby results in lower rate of economic growth.

Among the various instruments of fiscal policy, perhaps tax policy is the most important determinant of the efficiency of resource use. Therefore, we shall examine if over the years it has not exercised any negative effects on the productive activity. ***During the first four decades of economic planning, the reliance on commodity taxation had increased and it accounted for around 84 per cent of the tax revenue of the Central government in 1990-91. However, during the period of economic reforms, the trend was reversed and the ratio of indirect tax revenue to total tax revenue declined to 51.7 per cent in 2016-17.***

Among the indirect taxes, the preponderant role has been played by customs and excise duties at the Central government level and the sales tax at the State government level. These taxes have been generally levied mainly on revenue-raising considerations and have sometimes resulted in efficiency losses. The case of customs duties is particularly mentioned to prove this point. In recent years, a number of studies have revealed that the structure of customs duties along with restrictive controls has provided effective protection to a number of industries, and as a result there has been unnecessary loss of efficiency in resource use. Recently in the light of the recommendations of the Chelliah Committee, some corrective measures have been undertaken and by lowering down the import duties, unwarranted protection to the industries has been withdrawn.

Since the beginning of economic planning there has been proliferation of non-departmental public enterprises. Investment in them over the various plan periods has been massive, yet they have failed to generate the expected amount of surpluses. This has raised serious doubts about their efficiency level. These enterprises have been set up to realise objectives other than the maximisation of private profit. Therefore, it would be wrong to evaluate their performance on this criterion. Nevertheless, the studies at the enterprise, sub-sector and sectoral levels suggest that the efficiency of resource use in public sector enterprises is not altogether satisfactory.

In India, a sizeable black economy exists which poses serious problems for the allocative dimensions of fiscal policy. Shankar Acharya states, "To begin with, widespread tax evasion blunts the allocative signals of the tax system. When, in the case of a large number of manufacturers and traders, the tax dues are believed to be the end product of a complicated interaction between the tax statutes, the evasion opportunities, the enforcement machinery and its susceptibility to corruption, it is idle to pretend that only the first of these factors, namely, the tax laws, is solely responsible for the resource allocation implications of tax system."[2] There is now considerable evidence which suggests that corporate enterprises and other business firms in arriving at decisions on investment, production and sale consider not only the tax laws but also the possibilities of avoiding tax burden through legal and illegal methods. ***The presence of a large black economy which generates income equalling 40 per cent of GDP also vitiates the allocative impact of the fiscal policy on the expenditure side.*** The widespread leakages from government expenditure programmes adversely affect the efficiency of public expenditure which means that in practice the actual return from public expenditure is far less than the anticipated return.

Fiscal Policy and Equity

It is often doubted whether India's fiscal policy conforms to the principle of equity. During the first four decades of economic planning, the share of direct taxes in total tax revenue had fallen from 40 per cent to 16 per cent. However, during the 1990s the trend was reversed and thus in 2017-18 direct taxes accounted for 48.3 per cent of the total tax revenue of the Central government. Many economists have argued that direct taxes are generally progressive. However, the progressivity is reduced substantially because of large number of exemptions and concessions provided under the direct tax laws. Moreover, there is large-scale tax

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evasion often with the connivance of bureaucracy and the ruling class. It is an acknowledged fact that there is a large undisclosed income in the country on which no tax is paid. This income is mostly in the hands of industrialists, traders, land mafia, professionals, bureaucrats and politicians. Therefore, the sharpness of progression in nominal rates does not guarantee that the principle of equity in direct taxation will not be violated. As far as indirect taxes are concerned, they are generally believed to be regressive.

For assessing the equity implications of the fiscal policy, it is also necessary to analyse as to who benefits from public expenditure. For India so far no comprehensive study has been made on this aspect of the fiscal policy. Taking a partial view some economists have recently argued that the poverty alleviation programmes reflect the intentions of the government. However, this way of looking at the issue is not correct. The fact of the matter is that the benefit of most of the government expenditure has hardly reached the poorest of the poor. After all who does not know that poor rarely benefit from expenditures on defence, public administration, higher education and urban based medical facilities. Even the benefit of most development expenditure rarely trickles down to reach the poorest of the poor. Therefore, the equity implications of the public expenditure are clear; the poor have benefited the least from them.

THE FISCAL IMBALANCE AND DEFICIT FINANCE

Upto the mid 1980s fiscal imbalance was seen in terms of the overall budget deficit measured by the gap between the expenditure and the receipts under the revenue and capital accounts taken together. ***This gap was sought to be filled by deficit financing which in India is defined as borrowings from the Reserve Bank of India against the issue of Treasury Bills and running down of accumulated cash balances.*** When government borrows from the Reserve Bank of India, it merely transfers its securities to the Bank who, on the basis of these securities, issues more notes and puts them into circulation on behalf of the government. ***This amounts to creation of money.***

Rationale for Deficit Financing

In a developing economy when the government fails to mobilise adequate resources for the public sector plan from domestic as well as external sources, recourse to deficit financing becomes necessary. Alternatively, the government can cut the size of the plan itself and that in turn will slash the demand for investible funds. It will, however, have serious repercussions on growth. Therefore, a developing country often has to make a difficult choice between two regrettable necessities, *viz.*, a lower growth rate and an inflationary price rise. Obviously, of the two, price rise is a lesser evil and is thus to be preferred to a lower growth rate. According to the planners, over the years India has been facing precisely this problem. Pramit Chaudhuri rejects this contention. He asserts that the government did not make adequate efforts to mobilise resources from domestic sources even at a time when "there was an excess supply of saving from within the private sector."[3] In fact the failure of the government to raise adequate resources is largely on account of its inability to use its powers of taxation systematically.

To sum up, ***the need for deficit financing in this country arises on the one hand from the failure of the government to mobilise the desired volume of surplus for the public sector plans and on the other, from its rapidly growing expenditures (mostly on unproductive non-developmental activities).***

Consequences of Deficit Financing

Deficit financing can play a useful role during the phase of depression in a developed economy. During this phase, the level of expenditure falls down to a very low level and the banks and the general public are in no mood to undertake the risk of investment. They prefer to accumulate idle cash balances instead. The machinery and capital equipment are all there, what lacks is the incentive to produce due to deficiency in aggregate demand. If the government pumps in additional purchasing power in the economy (through deficit financing), the level of effective demand is likely to increase. To meet this demand, the machinery and capital equipment lying hitherto unused will be pressed into operation. The level of production will, accordingly, increase. If this increase is able to match the increase in the aggregate spending level, inflationary tendencies will not be generated.

Conditions in underdeveloped countries are different. This is on account of the fact that in these countries, the capital equipment does not exist but has to be built up. Thus, while newly created money (as a result of deficit financing) leads to an immediate increase in the purchasing power in the hands of the people, the production of goods does not increase simultaneously. In fact, there is likely to be a considerable time-lag in the generation of extra purchasing power and the availability of additional consumer goods. In the meantime, the level of prices increases. According to Meier and Baldwin, ***capital accumulation in developing countries through deficit financing is likely to generate inflation because in these countries "the propensity to***

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consume is high, there are many market imperfections, there is little excess capacity in plant and equipment, and the elasticities of food supplies are low."[4]

Because of the general poverty of the masses, their levels of food consumption are very low. Therefore, their first temptation is to spend more on food consequent upon an increase in income. However, it is difficult to increase the supply of food items in the short run (even in the long run an increase in their supply requires strenuous efforts in the form of implementing land reforms, adopting new agricultural techniques, etc.). Therefore, demand for food items is likely to be pushed up to a far higher level as compared to their supply resulting in a rise in their prices. In the developing countries, prices of food items work as a 'signal' for the prices of other goods and they also start rising. The high propensity to consume compounds the inflationary impact of deficit financing as a substantial proportion of the increased income is spent on consumption. Because of market imperfections, the composition of total output and the productive structure of the economy remain much more fixed over time in an underdeveloped country as compared to a developed country. This makes for low elasticity of supply of output.

If additional resources generated through deficit financing are utilised for the production of consumption goods, the inflationary impact is likely to be restricted as the additionally created money supply will be matched by an increased amount of consumption goods. Examples of programmes wherein increased expenditure is not likely to result in inflation are small-scale enterprises, distribution of new-high yielding varieties of seeds, fertilisers, etc., to farmers, minor irrigation schemes, etc. However, the important task before developing countries is not to increase the output of consumption goods but to build up costly capital equipment, lay down railway tracks, improve communication facilities, build up huge hydroelectric and thermal power plants, etc. Therefore, the extra money created through deficit financing is likely to be spent on financing these projects. As a result, there is no likelihood of an increase in consumer goods in the near future and inflation would almost inevitably result.

According to some economists, even if deficit financing tends to be inflationary it carries no danger as long as the inflationary pressures are mild. In fact, a mild inflationary situation affords incentives to the producers who, in the expectation of increasing profits, are likely to raise the level of production and, in the process, utilise idle capital and labour resources of the economy.

THE FISCAL IMBALANCE AND THE NEW FISCAL APPROACH

On account of growing burden of non-development expenditure, the fiscal situation deteriorated throughout the 1980s and assumed crisis proportions by the beginning of 1991-92. Throughout the 1980s all the major indicators of fiscal imbalance largely reflected that it was on the rise. The process of macroeconomic stabilisation undertaken within a neo-liberal framework brought about a shift in the approach towards the measurement of fiscal imbalance. Following the US budgetary practices the concept of ***fiscal deficit*** has come into use. ***It is measured by the difference between total government expenditure over government revenue and grants and thus reflects the total resource gap.*** This measure of deficit has been adopted by the IMF as the principal policy target in evaluating the performance of countries seeking assistance.[5]

Some other indicators used to measure fiscal imbalance are the ***revenue deficit*** and the ***primary deficit. The revenue deficit is defined as the difference between revenue expenditure (i.e., those government expenditures which do not result in capital formation) and current revenues. The primary deficit is the fiscal deficit less interest payments.***

The Fiscal Imbalance and Fiscal Correction

The trends in various indicators of fiscal imbalance since 1980-81 are given in Table 53.1. From this table, it is clear that between 1980-81 and 1990-91 the revenue deficit of the Central government rose substantially. The revenue deficit rose from 1.5 per cent of GDP in 1980-81 to 3.3 per cent in 1990-91. This fact unambiguously suggests that the fiscal situation was under mounting pressure throughout the decade long period from 1980-81 to 1990-91. In this period the gross fiscal deficit of the Central government rose alarmingly. From 5.6 per cent of GDP in 1980-81, it rose to 7.6 per cent in 1990-91.

Such a fiscal situation was unsustainable and required immediate corrective measures. Accordingly, the regular Budget for 1991-92 which was presented to Parliament on July 24, 1991, announced some major steps to correct the fiscal imbalance. Though the burden of achieving reduction in fiscal deficit fell heavily on expenditure side, the Budget contained some proposals for raising additional revenue. After the Budget for 1991-92 was passed, the Government imposed a 5 per cent cut on the expenditure provisions contained in the sanctioned Budget estimates for 1991-92 of all Ministries/Departments.

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These measures enabled the government at the Centre to reduce fiscal deficit from about 7.6 per cent of GDP in 1990-91 to 5.4 per cent of GDP in 1991-92 and 4.7 per cent of GDP in 1996-97. Fiscal deficit rose to 5.7 per cent of GDP in 1997-98 and stood at 6.0 per cent of GDP in 2001-02.

Since 1997-98 two factors contributed to increasing fiscal deficit. ***First,*** reduction in tax rates adversely affected tax revenue. ***Second,*** non-development expenditure continued increasing due to casual approach of the government. There was, however, a steady decline in fiscal deficit-GDP ratio subsequently as a result of the enactment of Fiscal Reforms and Budget Management (FRBM) Act in 2004. The fiscal deficit of the Central government declined to 3.3 per cent of GDP in 2006-07 and further to 2.5 per cent of GDP in 2007-08 as a result of substantial effort at fiscal correction. The target for fiscal deficit was kept at 2.5 per cent of GDP for the financial year 2008-09. However, because of slowdown in the economy in the latter half of this year, there was a fall in tax collections. At the same time, the government had to increase expenditures substantially in a bid to generate demand in the economy. As a result, fiscal deficit increased considerably to 6.0 per cent of GDP — the highest in the last seven years.[6] The fiscal deficit rose further to 6.5 per cent of GDP in 2009-10. It declined thereafter and stood at 3.5 per cent in 2017-18 and 3.4 per cent of GDP in 2018-19. Centre's fiscal deficit in 2019-20 is projected at 3.3 per cent of GDP.

Interest payments. Interest payments which contributed most to the fiscal imbalance have continued to rise. According to Raja J. Chelliah, "the net interest payments by the government can be reduced by bringing down the gross interest payments or by increasing the income from the government's investments. It does not seem feasible to increase the latter. It is, therefore, necessary to find ways of reducing the gross interest payments by the government."[7] Chelliah is right in his assertion that the government must find ways to reduce interest payments, but the government seems to be complacent about it. This is clear from the fact that interest payments of the Central government rose from ₹ 26,596 crore in 1991-92 to ₹ 59,478 crore in 1996-97 and to ₹ 5,30,843 crore in 2017-18. Presently the government has no other option except to effect reduction in the existing stock of debt. ***Since it is now possible to retire a part of the external debt due to comfortable position of foreign exchange reserves, debt reduction need not be confined to internal debt. The resources for liquidating a part of the internal debt can be raised by disinvesting in public enterprises and selling a part of vast real estate that the government owns in the country.***

Non-interest expenditure. In India, although there is some scope for raising tax revenue, the liberalisation approach of the government would deter it from doing so. Therefore, ***if fiscal deficit is to be brought down the growth of all the major categories of non-interest expenditure has to be slowed down considerably. In some cases it is both desirable and feasible to effect reduction in the expenditure. From this point of view experts now particularly mention subsidies, capital assistance to non-viable and inefficient enterprises, government's consumption expenditure related to staff and defence expenditure.***

Major subsidies provided by the Centre are on food, fertilisers and petroleum. Although the government has time and again expressed its resolve to cut down the burden of subsidies, they have actually increased over time. The major subsidies added upto ₹ 12,158 crore in 1990-91. They are estimated to have risen to as high as ₹ 2,64,125 crore in 2017-18 (₹ 1,40,282 crore food subsidy, ₹ 64,973 crore fertiliser subsidy, ₹ 24,460 crore petroleum subsidy, ₹ 23,635 crore interest subsidy and ₹ 10,775 crore other subsidies).

The government has reduced budgetary support to the plan investment by public enterprises. In future, non-viable public enterprises should be closed down and other loss making enterprises should be advised to revise their pricing policies to wipe out their losses. Regarding the government's consumption expenditure related to staff, there seems to be no choice except to reduce it. Over the years, the government has over-extended itself and there is now considerable overstaffing in government departments. The government will have to find ways and means to shed the surplus staff. Meanwhile, austerity measures must be imposed on all government personnel.

Themes of the 'New Fiscal Policy'

In the broad framework of the economic liberalisation approach of the post-1991 reform period, the major themes of the fiscal policy have been concretised in this country. There is broad agreement on these themes and they can be summarised as follows.

"1. A systematic effort to ***simplify*** both the tax structure and the tax laws;

2. A deliberate shift to a regime of ***reasonable direct tax rates, combined with better administration and enforcement***, to improve compliance and raise revenues;

3. The fostering of a ***stable and predictable*** tax policy environment;

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Table 53.1

Central Government Deficit
(per cent of GDP at Current Market Prices)

Years/Period	*Revenue Deficit*	*Gross Fiscal Deficit*	*Gross Primary Deficit*
1980-81	1.4	5.6	3.8
1985-86	2.0	7.6	5.0
1990-91	3.2	7.6	4.0
1991-92	2.4	5.4	1.4
1992-93	2.4	5.2	1.2
1995-96	2.4	4.9	0.8
1996-97	2.3	4.7	0.5
1997-98	3.0	5.7	1.5
2000-01	3.9	5.5	0.9
2001-02	4.2	6.0	1.4
2002-03	4.2	5.7	1.1
2005-06	2.5	4.0	0.4
2006-07	1.9	3.3	−0.2
2007-08	1.0	2.5	−0.9
2008-09	4.5	6.0	2.6
2009-10	5.2	6.5	3.2
2010-11	3.2	4.8	1.8
2011-12	4.5	5.9	2.8
2012-13	3.7	4.9	1.8
2013-14	3.2	4.5	1.1
2014-15	2.9	4.1	0.9
2015-16	2.5	3.9	0.7
2016-17	2.1	3.5	0.4
2017-18	2.6	3.5	0.4
2018-19	2.3	3.4	0.3

RE: Revised Estimate; BE: Budget Estimate

Sources: (*i*) Reserve Bank of India, *Handbook of Statistics on the Indian Economy* 2017-18 (Mumbai, 2018), Table 234, p. 362.

4. Greater recognition and ***weight given to the resource allocation and equity consequences of taxation;***
5. More reliance on ***non-discretionary fiscal and financial instruments*** in managing the economy, as compared to ad hoc, discretionary physical controls;
6. Concerted efforts to ***improve tax administration*** and reduce the scope for arbitrary harassment;
7. Growing appreciation of the ***links between fiscal and monetary policy***;
8. Fresh initiative to ***strengthen methods*** of expenditure control."[8]

FISCAL RESPONSIBILITY IN INDIA

In the 1990s, with the resurgence of the neo-classical ideology, balanced budget received axiomatic acceptability at the international level. Since most governments failed to pursue this policy voluntarily, it was suggested that the fiscal balance should be restored by imposing legal responsibility on the government. The fashion of legal restraints on government fiscal behaviour was set by the United States, where in the mid-1980s the Balanced Budget and Emerging Deficit Control Act (Gramm-Rudman-Hollings Act) required a steady decline in the federal government's deficit to zero within a stipulated and fairly short time-frame. Such a legal binding on government in fiscal matters is extreme by any standard. Nevertheless, besides the USA, some other countries have opted for such an extreme measure and a few other countries preferred to pursue balanced budget policies without legal stipulation. India opted for the legal course in 2000 after having failed to restore fiscal balance for about a decade.

The Fiscal Responsibility and Budget Management (FRBM) Act

The Committee on Fiscal Responsibility Legislation was constituted on January 17, 2000 to look into various aspects of fiscal system and recommend a draft legislation on fiscal responsibility of the government. It was announced in the Budget for 2000-01 that the government intended to create a strong institutional mechanism embodied in Fiscal Responsibility Act to restore fiscal discipline at the level of the Central government. Accordingly, the Fiscal Responsibility and Budget Management (FRBM) Bill 2000 was introduced in Lok Sabha in December 2000. The Preamble to the Bill states its objectives as: "To provide for the responsibility of the Central government to ensure inter-generational equity in fiscal management and long-term macroeconomic stability

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by achieving sufficient revenue surplus, eliminating fiscal deficit and removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the Central government borrowings, debt and deficits, greater transparency in fiscal operations of the Central government and conducting fiscal policy in medium-term framework and for matters connected therewith or incidental thereto."

The FRBM Bill was totally undemocratic in its approach as it denied freedom to future governments in respect of fiscal management. The aim of the FRBM Bill was to bind future governments to a pre-specified fiscal policy framework which is an entirely anti-democratic measure. The Bill was referred to a select Committee of Parliament which after serious deliberations decided to reject it. The Parliamentary Standing Committee that had studied the original Bill made certain recommendations to dilute various provisions in the Bill. The diluted version of the original Fiscal Responsibility and Budget Management Bill was passed by the UPA government immediately after assuming power in July 2004.

The FRBM Act which became effective from July 5, 2004 mandated the Central Government to eliminate revenue deficit by March 2009 and subsequently build up a revenue surplus. The Act also mandated the Central government to reduce fiscal deficit to an amount equivalent to 3 per cent of GDP by March 2009.

The FRBM Act provides for greater transparency in fiscal operations, quarterly review of fiscal situation and regulating direct borrowing from the RBI in a bid to check borrowing and control expenditure to effect fiscal discipline. The original version of the FRBM Bill had prohibited direct borrowing from the RBI after three years of the passage of the bill except to meet temporary needs. The present FRBM legislation has done away with this provision.

The FRBM legislation has now made it mandatory for the Finance Minister to make an annual statement to Parliament on the fiscal situation besides explaining any deviation in meeting the fiscal obligations cast on the Centre. The legislation provides for responsibility of the Central government to ensure inter-generational equity in financial management and long-term macroeconomic stability by achieving sufficient revenue surplus.

The rules made under FRBM Act specify the annual targets for reduction of fiscal and revenue deficits. The rules also prescribe the formats for medium term fiscal policy statement, the fiscal policy strategy statement and the macroeconomic framework statement to be presented to Parliament along with the annual financial statement.

Appraisal of the FRBM Legislation

The Fiscal Responsibility and Budget Management legislation is an attempt on the part of the Central government to commit itself and tie hands of future governments in order to ensure fiscal discipline. The desirability of fiscal discipline is generally accepted, yet there are serious misgivings about the coverage of the legislation and its chosen targets.

1. Misgivings about the revenue deficit target. There is broad consensus that the revenue deficit is to be brought down to zero. In the past, despite general agreement on this issue successive Central governments had failed to reduce revenue deficit during the 1990s. In fact, the revenue deficit of the Central government was 3.6 per cent of the GDP in 2003-04 as against 2.4 per cent in 1996-97. This appalling situation developed on account of two reasons. First, Central tax revenue (net) to GDP ratio declined from 7.6 per cent in 1990-91 to 6.8 per cent in 2003-04. Second, interest payments, revenue subsidies, defence expenditure and other non-plan expenditures rose substantially. If restrictions are imposed on the government to reduce revenue deficit, the real possibility is that the government may cut down social sector spending — especially on basic health and basic education — very severely.[9]

The problem with basic health and basic education is that there is no lobby to push the government for these services. Ajit Karnik states, "In the absence of such a lobby, there is the danger that in the endeavour to attain the target of zero RD (revenue deficit), the government may squeeze social sector spending still further."[10] This will surely be disastrous for large sections of the Indian population.

2. Low levels of capital expenditure. One of the major defects of government finances during the post-reform period has been the declining capital expenditure-GDP ratio. The capital expenditure-GDP ratio which was 5.6 per cent of GDP in 1990-91 fell to 2.7 per cent in 2001-02. After registering some increase in 2003-04 and 2004-05, it fell to just 1.6 per cent in 2006-07. It stood at 1.8 per cent of GDP in 2016-17 and 1.6 per cent of GDP in 2017-18.

3. Neglect of equity and economic growth. Under the Fiscal Responsibility and Budget Management legislation, the dice is heavily loaded against investments in not only human resources development, but also infrastructure because of the view that on account of their large externalities, a major part of the return on such investments would not directly contribute to the government revenue. One of the major omissions of the FRBM legislation "thus consists in the absence of any targets for time-bound, minimum improvements in these areas which are crucial for both equity and economic growth."[11]

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4. Lack of seriousness about financing public expenditure. The Fiscal Responsibility and Budget Management legislation does not address the problem of financing public expenditure in a serious manner. During the 1990s the tax-GDP ratio declined significantly. Hence, the need to raise this ratio should have received top priority under the legislation. But this was not to be. There is no target under the legislation for the tax-GDP ratio. As a matter of fact, a large number of tax concessions continue to be given most of which cannot be justified. The problem of financing public expenditure is callously dealt with by imposing a restriction on the Central government to borrow from the RBI to finance government expenditure, current or capital. This forces the government to incur enormously high interest cost on all its debt.

The legislation could have provided for raising tax-GDP ratio by making improvements in tax administration and collections and measures to rein in tax evasion. However, this aspect received virtually no attention in the legislation. Moreover, the legislation does not seem to recognise that borrowing from the central bank on a moderate scale for financing government investment serves useful purpose in an economy like ours. As a matter of fact, it has an important role to play in promoting the basic objectives of economic growth and equity and minimising the adverse effects of debt and deficits.

5. Flawed assumptions of the FRBM legislation. The FRBM legislation is based on the following assumptions:

(*i*) Lower fiscal deficits lead to higher and more sustained growth.

(*ii*) Large fiscal deficits necessarily lead to higher inflation.

(*iii*) Large fiscal deficit increases external vulnerability of the economy.

C.P. Chandrasekhar and Jayati Ghosh reject these assumptions as they are not tenable. They examine each of these assumptions and point out their unsustainability. Commenting on the first assumption that lower fiscal deficits lead to higher and more sustained growth, they remark, "This need not be the case, since if the deficit is dominantly in the form of capital expenditure, it contributes to future growth through demand and supply linkages. Also, since there is a strong positive correlation between public and private investment, ...more such public spending would stimulate more overall investment and thus growth."[12]

Rejecting the validity of the second assumption, C.P. Chandrasekhar and Jayati Ghosh argue that inflation is caused by the *ex ante* (planned) excess of aggregate demand over aggregate supply, which may come from public or private sectors. Therefore, fiscal deficit must not be blamed all the time for higher inflation. In India, the rate of inflation had fallen during the late 1990s despite fiscal deficit hovering around 5.9 per cent of the GDP.

The third assumption is also incorrect. The external vulnerability depends more on capital and trade account convertibility and the perception of international finance rather than fiscal discipline. Therefore, capital flight may begin at a time when fiscal deficit is low. The higher fiscal deficit may not necessarily cause external crisis. In this country we have managed to build large foreign exchange reserves despite the fact that the fiscal deficit has not come down.

Having convincingly shown that the assumptions of the Fiscal Responsibility and Budget Management legislation are theoretically incorrect, C.P. Chandrasekhar and Jayati Ghosh conclude that the restraining measures under the FRBM Bill (now FRBM Act) "are both unwarranted and unnecessary, and if implemented they would actually be substantially detrimental to the material interest of most of the Indian people. This is because such measures would not only force deflation on the economy, but also involve reductions in public expenditure to meet these very severe criteria, so that public expenditure which is important and necessary for growth and welfare would not be made."[13]

As already stated earlier, because of slowdown in the economy during the second half of the financial year 2008-09, tax collections in this year fell. At the same time, the government was obliged to undertake massive expenditure programmes to raise demand to boost the economy. As a result, target deadlines under the FRBM Act have been ignored. In fact, fiscal deficit in 2008-09 was as high as 6.0 per cent of GDP which rose further to 6.5 per cent of GDP in 2009-10. This is the position when 'oil bonds' issued to oil-marketing companies and 'fertiliser bonds' issued to fertiliser companies are not included in the calculation of fiscal deficit. If these 'off-budget liabilities' are also included, figure for fiscal deficit would be much higher. For example, the Prime Minister's Economic Advisory Council reported in end-July 2008 that "total off-budget liabilities of the Centre could exceed 5 per cent of GDP".[14] This is over and above the Central fiscal deficit of 6 per cent of GDP in 2008-09. Accordingly, the 'true' fiscal deficit of the Centre in 2008-09 probably exceeded 10 per cent of GDP. Although the government claims that fiscal deficit of the Centre fell from 6.5 per cent of GDP in 2009-10 to 3.4 per cent in 2017-18, many economists have maintained that these figures have been arrived at by 'statistical manipulation' and 'accounting jugglery'. According to these economists, the actual deficits of the Central government are much more than the figures indicate.

Another matter of concern is that the combined fiscal deficit of the States has seen a rise in recent period – from 1.93 per cent of GDP in 2011-12 to 3.07 per cent in

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2017-18 and stood at 2.68 per cent in 2018-19. Three factors are likely to make the threat to the health of State finances even more serious. One, the key reasons for an increase in the fiscal deficit at the State level are lower growth in revenue and a faster rise in expenditure. These, in turn, make the task of bridging the gap more onerous. Two, the impact of the Seventh Pay Commission's recommendations on the States is not yet fully evident. As more and more States increase wages in tune with the recommendations of the Commission, the State's fiscal deficit for the next couple of years is likely to worsen. Finally, the launch of the goods and services tax (GST) has introduced an element of uncertainty to the flow of tax revenue to State governments' coffers.

Fiscal Responsibility and Budget Management (FRBM) Committee

The government appointed a five-member Committee in May 2016 under the chairmanship of N.K. Singh to review the Fiscal Responsibility and Budget Management (FRBM) Act and to examine a changed format including FRBM targets. The Committee was an outcome of intense debate on FRBM implementation. There was difference of opinion about the need for adopting a fixed FRBM target like fiscal deficit. Some economists argue that the FRBM target which is usually expressed in terms of fiscal deficit, need not be followed during the time when the government has to spend more to fight recession and support economic growth. Some other economists believe that a target oriented fiscal deficit (as under FRBM) is necessary to ensure fiscal discipline. During Budget Speech in 2016, the Finance Minister expressed this debate thus: "There is now a school of thought which believes that instead of fixed numbers as fiscal deficit targets, it may be better to have a fiscal deficit range as the target, which would give necessary policy space to the government to deal with dynamic situations. There is also a suggestion that fiscal expansion or contraction should be aligned with credit contraction or expansion, respectively, in the economy".

Terms of Reference of N.K. Singh Committee. The terms of reference of N.K. Singh Committee were as under:

1. Review of the running of FRBM Act in the past and suggest changes to meet contingencies. The Committee was asked to review the working of the FRBM Act during the last 12 years. It was also asked to suggest the way forward, keeping in view the broad objective of fiscal consolidation and prudence and the changes required in the context of the uncertainty and volatility in the global economy.

2. Examining various associated facts. The Committee was asked to look into the various aspects and factors that have to be considered while determining the FRBM target.

3. Examining the feasibility of flexible fiscal deficit target. The Committee was required to look into the possibility of a 'fiscal deficit range' or flexible fiscal deficit target instead of a fixed target (for example, 3 per cent of GDP at present).

4. Aligning fiscal activities with credit cycle. The Committee was asked to suggest whether the government need to align or adjust its fiscal expansion/contraction with credit expansion/contraction in the economy.

Report Submitted by the Committee. The Committee submitted its report to the Finance Minister on January 23, 2017 and is being examined by the government. The Report has four volumes. The first volume addresses the issue of fiscal policy and roadmap, international experience and the Committee's recommendations on it. The second volume refers to views of international organisations like OECD, World Bank, ILO which made presentations before the panel. The third volume deals with Centre-State issues. The fourth volume includes views of domain experts, both national and international, and what they believe an appropriate fiscal policy would be.

The Report of the N.K. Singh Committee was made public on April 11, 2017. It has suggested a new fiscal framework that has recommended ***bringing down the debt-to-GDP ratio to 60 per cent by 2023*** (40 per cent for the Centre and 20 per cent for States). Since the States are already meeting this target (see Table 52.3 of Chapter 52 in this context), this means that the entire burden for reducing the debt to the recommended limit will have to be borne by the Centre.

The Committee has also recommended that ***the Central government should target a fiscal deficit of 3 per cent of GDP in years upto March 31, 2020 and to 2.5 per cent of GDP by 2022-23.*** It, however, suggested 'escape clause' in case of over-riding consideration of national security, acts of war, calamities of national proportion and collapse of agriculture severely affecting farm output and incomes. Also, 'far-reaching structural reforms in the economy with unanticipated fiscal implications' too can trigger deviation from the targets. However, the deviations from the stipulated fiscal deficit target shall not exceed 0.5 percentage points in a year. The Committee has also recommended that the revenue deficit should also be brought down in phases to touch the level of 0.8 per cent of GDP in 2022-23.

Another important recommendation of the N.K. Singh Committee is that ***the Centre should replace the existing***

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FRBM Act, 2003, with a new law and also set up a Fiscal Council.

New FRBM Framework: Union Budget 2018-19

In the Union Budget 2018-19, the Finance Minister accepted the key recommendations of the FRBM Committee relating to adoption of the debt rule and to bring down Central government's debt-to-GDP ratio to 40 per cent. The government also accepted the recommendation to use fiscal deficit target as the key operational parameter. The new FRBM framework as adopted in the Union Budget, 2018-19, contains the following elements:

- To target simultaneously on fiscal deficit and debt.
- To target fiscal deficit as an ***operational target*** and to ensure that the fiscal deficit of 3.0 per cent of GDP is reached by the government by financial year 2020-21.
- The Central government shall endeavour to follow a declining debt trajectory so as to reach a debt target of 40 per cent of GDP as also to keep the general government debt at 60 per cent of GDP by financial year 2024-25.
- Inserting adequately defined escape and buoyancy clauses to determine when the target defined by the FRBM Act may be relaxed or tightened as the case may be.

In the new framework, ***the government will simultaneously target debt and fiscal deficit and do away with the revenue deficit target.*** As argued by Pinaki Chakraborty and Lekha Chakraborty, "can the movement of revenue deficit be ignored for the purpose of policy and prudent management of government finances" particularly given the fact that during the period of the last ten years (2008-09 to Budget Estimate of 2018-19), it is the revenue deficit that has driven the fiscal deficit (in 2008-09, revenue deficit was 75 per cent of the fiscal deficit, and in 2018-19, it is estimated to be 66.66 per cent of the fiscal deficit).[15]

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NOTES

1. Government of India, Planning Commission, *Seventh Five Year Plan* 1985-90, Vol. I (Delhi, 1985), p. 68.
2. Shankar Acharya, "India's Fiscal Policy", in Robert Lucas and Gustav F. Papanek (eds.), *The Indian Economy — Recent Development and Future Prospects* (Delhi, 1988), p. 294.
3. Pramit Chaudhuri, *The Indian Economy — Poverty and Development* (New Delhi, 1978), p. 84.
4. Gerald M. Meier and Robert E. Baldwin, *Economic Development* (Bombay, 1970), p. 382.
5. Raja J. Chelliah, *Towards Sustainable Growth: Essays in Fiscal and Financial Sector Reforms in India* (Delhi, 1996), p. 50.
6. It may be pointed out here that the figure of gross fiscal deficit for the year 2008-09 does not include ₹ 96,000 crore worth of bonds issued to oil and fertiliser companies. If these are also included, gross fiscal deficit for the year 2008-09 increases to 7.8 per cent of GDP.
7. Raja J. Chelliah, "Growth of Indian Public Debt" in Bimal Jalan (ed.), *The Indian Economy — Problems and Prospects* (New Delhi, 1992), pp. 219-20.
8. Shankar Acharya, *op. cit.*, p. 302.
9. Amiya Kumar Bagchi, "Neo-Liberal Reforms with Cosmetic Changes?", *Economic and Political Weekly*, August 7, 2004, p. 3574.
10. Ajit Karnik, "Fiscal Responsibility and Budget Management Bill — Offering Creditable Commitments", *Economic and Political Weekly*, January 19, 2002, p. 254.
11. Mihir Rakshit, "Restoring Fiscal Balance through Legislative Fiat — The Indian Experiment", *Economic and Political Weekly*, June 9, 2001, p. 2061.
12. C.P. Chandrasekhar and Jayati Ghosh, *The Market that Failed — A Decade of Neo-liberal Economic Reforms in India* (New Delhi, 2002), p. 84.
13. *Ibid.*, p. 86.
14. Quoted in Shankar Acharya, "Macroeconomic Performance and Policies, 2000-8", in Shankar Acharya and Rakesh Mohan (ed.), '*India's Economy — Performance and Challenges*' (New Delhi, 2010), p. 141.
15. Pinaki Chakraborty and Lekha Chakraborty, "New FRBM Framework", *Economic and Political Weekly*, March 3, 2018, p. 31.

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62 Chapter

ECONOMIC REFORMS AND LIBERALISATION

In early 1991, a major economic crisis surfaced in India. Most economists are now convinced that this crisis in the economy was the worst that this country had experienced since Independence. To tackle the problems emanating from this crisis, the government introduced a programme of *macroeconomic stabilisation* and *structural reforms*.

In this chapter, we shall discuss:

- The reasons for economic crisis in the early 1990s
- Macroeconomic stabilisation measures introduced in the post-reform period
- Measures introduced for structural reforms in the economy
- An appraisal of economic reforms.

THE ORIGIN OF ECONOMIC CRISIS IN THE EARLY 1990s

The problems of the economy in this country which assumed crisis proportions in 1991 did not develop suddenly. ***The origin of the crisis is directly attributable to the cavalier macro management of the economy during the 1980s which led to large and persistent macroeconomic imbalances.*** The widening gap between the revenue and expenditure of the government resulted in growing fiscal deficits which had to be met by borrowing at home. Further, the steadily growing difference between the income and expenditure of the economy as a whole resulted in large current account deficits in the balance of payments which were financed by borrowing from abroad. According to Deepak Nayyar, ***"The internal imbalance in the fiscal situation and the external imbalance in the payments situation were closely related, through the absence of prudence in the macro management of the economy."***[1] This was, however, not appreciated particularly during the 1980s and in an attempt to live beyond means, the economy was pushed into a deep economic crisis.

The Gulf crisis in the late 1990 sharply accentuated macroeconomic problems. There was also political instability in the country at this juncture. All these developments together eroded international confidence in the Indian economy and, as a result, this country's credit rating in the international capital market declined steeply. However, it has to be recognised that the problems of the economy did not assume crisis proportions abruptly. These problems, in fact, were very much there for years destroying the capacity of the economy to cope with any internal or external shocks. In the 1970s, the Indian economy was strong enough to bear much larger and more sustained oil shocks. But by 1990 the situation had changed so much that the minor oil shock made disproportionately large impact on the economy and a macroeconomic crisis erupted in the form of: (1) Unsustainable fiscal deficit; (2) Unsustainable current account deficit; and (3) Accelerating inflation.

The Fiscal Imbalance

The fiscal crisis in 1990 was not a coincidence. The fiscal situation had deteriorated throughout the 1980s due to growing burden of non-development expenditure. The gross fiscal deficit of the Central government which was 5.1 per cent of GDP in 1981-82, rose to 7.8 per cent in 1990-91. Since this fiscal deficit had to be met by recourse to borrowings, the internal debt of the Central government increased rapidly, rising from 33.3 per cent of GDP at the end of 1980-81 to 49.7 per cent of GDP at the end of 1990-91. This naturally made burden of servicing the debt onerous. Interest payments which were 2 per cent of GDP and 10 per cent of total Central government expenditure in 1980-81, rose to 3.8 per cent of GDP and 22 per cent of total Central government expenditure in 1990-91. How alarming this fiscal situation was, can be realised from the fact that in 1990-91 interest payments had eaten up 39.1 per cent of the total revenue collections of the Central government. This obviously was an unsustainable situation. ***The danger of the government falling into debt-trap was real.*** The government thus could not persist with its cavalier policy of growing reliance on borrowings to meet steadily increasing fiscal deficit to which unchecked growth of non-plan revenue expenditure was the major contributing factor.

Fragile Balance of Payments Situation

The balance of payments situation was highly precarious in 1991, but this was not unexpected. The

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current account deficit which was $ 2.1 billion or 1.35 per cent of GDP in 1980-81 rose to $ 9.7 billion or 3.69 per cent of GDP in 1990-91. These continuously growing deficits had to be financed by borrowing from abroad and, as a consequence, India's external debt rose from 12 per cent of GDP at the end of 1980-81 to 23 per cent of GDP at the end of 1990-91. This steadily growing external debt led to an increase in debt service burden from 10 per cent of current account receipts and 15 per cent of export earnings in 1980-81 to 22 per cent of current account receipts and 30 per cent of export earnings in 1990-91. These mounting strains during the 1980s stretched to the breaking point in 1991 due to the Gulf crisis. ***The balance of payments position was on the brink of disaster as in mid-January 1991 and again in late June 1991 the level of foreign exchange reserves dropped to levels which were not sufficient to finance imports of even ten days.***

Mounting Inflationary Pressures

The price situation was apparently not alarming during the second half of the 1980s as the average rate of inflation was 6.7 per cent per annum in terms of the wholesale price index. ***However, the rate of inflation rose to 10.3 per cent in 1990-91. In terms of the consumer price index, the rate of inflation climbed to 11.2 per cent per annum which was certainly a cause for concern. However, the most disquieting feature of this inflationary situation was that the prices of food rose substantially in spite of three good monsoons in a row.*** According to Deepak Nayyar, these "inflationary pressures in the economy did not surface out of the blue. The build-up was attributable to the large deficits, which were inevitably associated with a monetisation of budget deficits and an excessive growth of money supply. This liquidity overhang, in conjunction with real disproportionalities and underlying supply demand imbalances was bound to fuel inflation."[2]

ECONOMIC REFORMS IN INDIA

It is generally agreed in studies on Indian economy that the process of economic reforms was initiated in India by the government of P.V. Narasimha Rao in 1991 with the announcement of a number of measures for liberalizing the economy by the then Finance Minister Manmohan Singh. However, Arvind Panagariya has argued that the process of economic reforms was initiated during the second half of 1980s under the stewardship of Prime Minister Rajiv Gandhi. In support of his contention, he quotes from the Kingsley Martin Memorial Lecture, delivered in Cambridge in 1987 by I.G. Patel who approvingly described the reforms introduced by Rajiv Gandhi in the preceding one-and-a-half years as the 'New Economic Policy'. This new economi policy had moved the Indian economy toward increase outward and inward competition by the end of 1980s Panagariya emphasises the shift in the Industrial Polic Statement, 1990, towards large-scale liberalisation of industria policy. This policy provided compelling evidence that interna and external liberalisation had gained considerable politica acceptance at least a year before the balance of payment crisis. However, not being able to predict how the electorat might react, the politicians were still afraid to announc their conversion openly. "But they were sufficiently convince of the need for change to move forward to open the markets in larger steps than had been the case in the past."[3] In his own study, Panagariya prefers to term the perio since 1988 as the phase of economic reform. However, he himself admits that the 1991-92 liberalisation was substantially at variance from the piecemeal measures preceding it. "Whereas the prior liberalisation had been undertaken within the essential framework of investment, import licensing, and price and distribution controls, the 1991 reform abandoned that framework and moved some way toward replacing it with the market mechanism. Although the fears of politica backlash still compelled Finance Minister Manmohan Singh to represent the reforms as the continuation of the pas policies, ***the actual measures represented complete renunciation of the old policy framework and brought liberalisation out in the open.***"[4] It is precisely because of this reason that in most of the studies on Indian economy, the process of economic reforms is assumed to have started in 1991.[5] This is the approach that we shall also follow in the present chapter.

The process of economic reforms undertaken by the P.V. Narasimha Rao government consisted of two distinct strands — macroeconomic stabilisation and structural reforms. While stabilisation deals with demand management, structural reforms deal with sectoral adjustments designed to tackle the problems on the supply side of the economy.

MACROECONOMIC STABILISATION

Macroeconomic stabilisation (often called just stabilisation) involves returning to low and stable inflation and a sustainable fiscal and balance of payments position. Stabilisation is necessary to overcome a crisis but it assumes a special importance if structural reforms are also introduced together with stabilisation. This is because structural reforms often add to macroeconomic pressures. For example, in the short run, trade liberalisation may increase deficits in the balance of payments and financial sector reforms may worsen fiscal position by raising the cost of public borrowing.

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Therefore, stabilisation must accompany structural reforms and stabilisation policies have to be bold and effective, otherwise extra macroeconomic strains generated in the reforms process can disrupt the latter completely. Vijay Joshi and I.M.D. Little have argued, ***"In the longer run, structural reform is as helpful for stabilisation as stabilisation is for structural reform. In the absence of reform, losses of public enterprises would continue to burden the budget; trade restrictions would hamper the growth of exports; and compulsory government capture of private savings would erode fiscal discipline."***[6]

The macroeconomic stabilisation programme adopted by the government consisted of the following measures:

1. Control of inflation;
2. Fiscal correction; and
3. Improving the balance of payments position.

Control of Inflation

The rate of inflation in 1990-91 was above 10 per cent per annum. This could be brought down on the one hand by introducing fiscal and monetary discipline in the economy and on the other by improving output and supply position. It seems that the government's achievements are modest on both the fronts. In 1991-92, while output failed to increase over the 1990-91 level, the money supply rose by 20.6 per cent as a result of large accretion of foreign exchange reserves which were not sterilised. This naturally fuelled inflation and the wholesale price index rose by 13.7 per cent. In 1992-93, prices increased at an average annual rate of 10.1 per cent. Overall, the average annual increase in prices during the first three-post reform years was 10.7 per cent. The main reasons for this large increase in prices were heavy fiscal deficits and rise in administered prices. During 1995-96, the inflation rate was brought down to 8.0 per cent and in 1996-97 to 4.6 per cent. In 1997-98, the inflation rate was 4.4 per cent.

During the years 2000-01 to 2016-17, the years of relatively high average annual inflation, above 5.5 per cent, were the years of 2000-01, 2004-05, 2006-07, 2008-09, 2010-11, 2011-12, 2012-13 and 2013-14. All these were years of high fuel prices. The overall inflation rate in 2004-05 was 6.5 per cent which fell to 4.5 per cent in 2005-06 and stood at 6.6 per cent in 2006-07 and 4.7 per cent in 2007-08. However, inflationary pressures started building up towards the last quarter of 2007-08 and the inflation rate rose to 8.02 per cent in March 2008. As on August 9, 2008, the inflation rate touched the high level of 12.8 per cent. The second half of the year 2008-09 witnessed conditions of slowdown in the economy consequent upon recessionary conditions in the world economy. As a result, there was a drastic reduction in the inflation rate and it dropped to just 0.18 per cent in the week ended April 4, 2009. However, for the year as a whole, the average annual inflation rate was as high as 8.1 per cent. The average inflation rate was as high as 9.6 per cent in 2010-11 and 8.9 per cent in 2011-12. Data from 2012-13 are based on the new series with base 2011-12 = 100. According to this, the WPI inflation was 6.9 per cent in 2012-13 which fell to 5.2 per cent in 2013-14 and further to just 1.2 per cent in 2014-15. Average WPI inflation rate was negative at –1.7 per cent in 2015-16 and only 1.7 per cent in 2016-17. The average CPI (combined) inflation was as high as 10.2 per cent in 2012-13 but fell consistently thereafter and was only 4.9 per cent in 2015-16 and 4.5 per cent in 2016-17. Similar declining

Box 62.1

Economic Reforms in India

Macroeconomic crisis of the early 1990s – Three aspects

- Fiscal imbalance
- Fragile balance orf payments situation
- Inflationary pressures

The crisis made economic reforms necessary

Two distinct strands of reforms

1. **Macroeconomic Stabilisation – Demand Management**
   - Control of inflation
   - Fiscal adjustment
   - Balance of payments adjustment
2. **Structural Adjustments – Supply-side Management**
   - Trade and capital flows reforms
   - Industrial deregulation
   - Disinvestment and public enterprises reforms
   - Financial sector reforms

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trends were witnessed in the case of CPI (Industrial Workers), CPI (Agricultural Labourers) and CPI (Rural Labourers). In this context, please see Table 44.1 of Chapter 44. As stated in Chapter 44, the new monthly CPI (combined), with base 2012 = 100, is now taken as the measure of headline inflation and is tracked by the Reserve Bank to anchor its monetary policy. Under this policy of inflation targeting, the target was set to bring down CPI inflation rate to 6 per cent by January 2016. This target has been achieved as the headline inflation in terms of CPI (combined) was 4.9 cent in 2015-16 and 4.5 per cent in 2016-17. It fell further to 3.6 per cent in 2017-18.

Fiscal Adjustment

According to a widely held opinion in government circles, fiscal adjustment is necessary for dealing with the twin problems of high domestic inflation and large deficits in the balance of payments. Fiscal deficit of the Central government was less than 4 per cent of GDP at the beginning of the 1970s. It, however, rose to about 5.1 per cent of GDP by the beginning of the 1980s and was as large as 7.8 per cent of GDP in 1990-91. The factor which contributed most to the growing fiscal deficit was sharp deterioration of the balance on revenue account. In 1970-71, the government had a surplus on revenue account. The situation drastically changed during the 1980s, as by 1985-86 there was a revenue deficit of about 2.1 per cent of GDP which rose to 3.3 per cent in 1990-91. ***The government having recognised that such high levels of fiscal deficits, both overall and on revenue account were not sustainable, committed itself to a policy of fiscal adjustment.***

The Central government initiated a programme of fiscal adjustment under which its fiscal deficit which was around 7.8 per cent of GDP in 1990-91, was reduced to 5.6 per cent in 1991-92 and stood at 5.3 per cent in 1992-93. The Central government also announced its fiscal adjustment programme for the medium term according to which its fiscal deficit was expected to be brought down to about 3 to 4 per cent by the mid-1990s. However, the Central government found it difficult to realise this goal. The fiscal situation in fact deteriorated in 1993-94 and the fiscal deficit of the Central government once again rose to 7.0 per cent of GDP. After this, there was a decline in fiscal deficit for four years but in 1998-99, the fiscal deficit again rose to 6.5 per cent of GDP. This was followed by a reduction in fiscal deficit. The government adopted the FRBM (Fiscal Responsibility and Budget Management) Act in 2004 and in accordance with this Act, brought down the fiscal deficit to 3.3 per cent of GDP in 2006-07 and 2.5 per cent of GDP in 2007-08. However, the year 2008-09 witnessed a massive fiscal deficit of 6.0 per cent as, because of economic slowdown, tax revenues fell on the one hand, and the government announced a number of concessions and increased public expenditure to boost demand in the economy on the other hand. In 2009-10, the fiscal deficit of Central government rose further to 6.5 per cent of GDP. It fell thereafter to 4.8 per cent of GDP in 2010-11, 3.5 per cent of GDP in 2017-18 and 3.4 per cent of GDP in 2018-19.

In India, the fiscal imbalance has been caused mainly by imprudent increase in public expenditure. If fiscal imbalance is to be corrected, it is necessary to reduce the government expenditure to around 25 per cent of GDP. However, in 2016-17, the government expenditure constituted 29.3 per cent of GDP. ***Containment of public expenditure is essential, but the government's capital expenditures in key infrastructural and social sectors must not be curtailed.*** This would require concerted effort at containing the revenue expenditure, particularly the consumption expenditure of the government consisting mainly of defence expenditure and administrative expenditure, subsidy payments and interest payments.

Although for the purpose of fiscal adjustment containment of the government expenditure should receive priority, special effort at additional resource mobilisation through tax and non-tax sources is also necessary. According to the Planning Commission, ***"The required additional revenues may have to be generated by a judicious mixture of broadening the tax base, rationalising the tax rates and through non-tax sources."***[7] The government can also mobilise some resources by targeting black money which presently is estimated to be around 50 per cent of GDP.

An area where there is considerable scope for revenue mobilisation is public services. User charges on publicly provided utilities such as irrigation, electricity, water, road transport and higher education are much below their cost of provision. The overall recovery rates on services provided by the Central government are as low as about 35 per cent. They are even lower at about 14 per cent for the services provided by the State governments. Hence, unrecovered costs of public utilities are large and are a kind of subsidy to the users. ***The government can justifiably raise user charges on public utilities like electricity, irrigation, transportation and water.***

The government, however, does not seem to be serious about additional resource mobilisation through raising the recovery rates on public utility services. It has also failed to cut down its consumption expenditures and subsidy payments. Its interest payments continue to increase as there is no serious attempt to liquidate substantial part of the existing stock of internal debt. ***Having failed in adopting hard corrective measures, the government has opted for some soft options such as reduction in capital expenditures***

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and social services in real terms. A fall in capital expenditure by government is generally expected to cause an overall decline in the rate of capital formation, while the containment of expenditure on social services adversely affects the human well-being.

Balance of Payments Adjustment

At present balance of payments situation is not as precarious as it was in 1990-91. ***The level of foreign exchange reserves rose from a meagre $ 2.2 billion in March 1991 to $ 341.6 billion at end-March 2015 and further to $ 360.2 billion at end-March 2016.*** This accumulation of foreign exchange reserves suggests that the Indian economy has moved to a somewhat stable and sustainable balance of payments position in the post-reform period. The current account deficit was 3.1 per cent of GDP in 1990-91 but fell to 0.4 per cent in 1991-92 mainly due to import compression which in turn adversely affected the overall performance of the economy.

The government adopted a policy of import liberalisation in 1992-93 considering a relatively comfortable foreign exchange reserves position. This raised the balance of trade deficit from $ 2,798 million in 1991-92 to $ 5,447 million in 1992-93 and in the process the current account deficit climbed to 1.7 per cent of GDP. At this juncture the situation appeared to be slipping out of control but in 1993-94 an impressive growth of exports of the order of 20.2 per cent reduced the trade deficit bringing down the current account deficit to 0.4 per cent of GDP.

The trade deficit widened to $ 9,049 million in 1994-95 but there was some improvement in the invisibles account. Hence, the year 1994-95 ended up with a current account deficit of $ 3,369 million which was around 1.0 per cent of GDP. This was a sustainable balance of payments position and was not expected to present any financial problems. The current account deficit, however, rose to 1.7 per cent of GDP in 1995-96. This reflected the higher availability of external resources to bridge the higher investment-saving gap. Developments on the trade account during 1996-97 eased the pressure on the current account of the balance of payments and the current account deficit declined to 1.2 per cent of GDP in 1996-97 and further to 0.6 per cent of GDP in 2000-01. In 2001-02, the country witnessed a surplus on current account amounting to 0.7 per cent of GDP (this surplus had occurred after a gap of 24 years). This was followed by a surplus on current account in the next two years. It amounted to 2.3 per cent of GDP in 2003-04. After this, the country has again witnessed deficit in current account. It was 0.4 per cent of GDP in 2004-05 and 1.3 per cent of GDP in 2007-08. As a result of economic slowdown in 2008-09 following global recession, the current account deficit widened to 2.3 per cent of GDP in this year. This increased further to 2.8 per cent of GDP in 2009-10 and 2.7 per cent of GDP in 2010-11. Because of high imports (mainly due to high imports of petroleum and gold) and sagging exports, trade deficit rose to as high as 10.2 per cent of GDP in 2011-12 while surplus on invisibles account was 6.0 per cent of GDP. As a result, current account deficit was as high as 4.2 per cent of GDP in this year and this rose further to 4.8 per cent of GDP in 2012-13. There was a marked improvement in balance of payments in 2013-14 particularly because of restrictions on non-essential imports (like gold) and measures to augment capital flows. Current account deficit in this year was $ 32.3 billion which was 1.7 per cent of GDP. With net capital inflows of $ 47.8 billion in this year, there was a reserve accumulation of $ 15.5 billion in 2013-14. Current account deficit in 2014-15 was $ 26.9 billion which was 1.3 per cent of GDP. However, capital inflows increased considerably in this year to $ 88.3 billion with the result that there was a large accretion of $ 61.4 billion to foreign exchange reserves. Because of a sharp fall in the merchandise trade deficit in 2015-16, the current account deficit fell to $ 22.2 billion which was just 1.1 per cent of GDP. With capital inflows in this year at $ 40.1 billion, the level of foreign exchange reserves rose by $ 17.9 billion in 2015-16. Current account deficit in 2016-17 was $ 15.3 billion which was just 0.7 per cent of GDP (the lowest since 2007-08). With capital inflows in this year at $ 36.8 billion, the level of foreign exchange reserves rose by $ 21.5 billion in 2016-17. Current account deficit in 2017-18 was $ 48,717. However, capital inflows (net) were as high as $ 91,390 million with the result that their foreign exchange reserve increased by as much as $ 43,574 million.

Policies relevant to the balance of payments which were adopted during the past two-and-a-half decades were guided by both stabilisation and structural reform considerations. In India's case, the balance of payments problems arose largely from inadequate coverage of imports by export earnings. In the beginning of the 1980s, this coverage ratio was only 52.4 per cent and led to a massive trade deficit. There was some improvement in it during the 1980s and ***in 1990-91 export earnings accounted for about 66.2 per cent of the value of imports***. Obviously even this was an unsustainable position which required a series of moves on the exchange rate and the exchange rate regime.

To begin with, in July 1991 there was a devaluation of rupee by 18-19 per cent. This was followed by the liberalised exchange rate management system (LERMS) in the budget for 1992-93. Under this system, a dual exchange rate was fixed under which 40 per cent of foreign exchange was to be surrendered at the official rate while the remaining

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60 per cent was to be converted at a market determined rate. The 1993-94 Budget adopted the unified exchange rate system. This system has been in operation since then. The experience with this system has been satisfactory as the period since 1993 has been marked by orderly conditions in the foreign exchange market, excepting a few episodes of volatility. ***The exchange rate management policy of the Reserve Bank in this period has been a policy of 'managed float regime' – i.e., the Reserve Bank has focused on managing volatility with no fixed target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. According to the Reserve Bank, this policy has withstood the test of time by ensuring a judicious mixture of 'flexibility' and 'pragmatism'.*** The average annual exchange rate of rupee in 2011-12 was $ 1 = ₹ 47.92 depreciating to $ 1 = ₹ 67.07 in 2016-17. ₹ 64.45 in 2017-18 and further to $ = ₹ 69.92 in 2018-19. Exchange rate at end-March 2019 was $ 1 = ₹ 69.48.

STRUCTURAL REFORMS

Since July 1991 comprehensive liberalisation measures have been undertaken to improve the supply-side of the economy. Among these the more important are: (1) Trade and capital flows reforms; (2) Industrial deregulation; (3) Disinvestment and public enterprise reforms; and (4) Financial sector reforms. According to Montek Singh Ahluwalia, "***it is the structural reform component that signalled a paradigm shift in the way the economy was to be managed.*** The earlier suspicion of the private sector – and of markets in general – gave way to a new emphasis of freeing the creative energies of the private sector by allowing it to respond to market forces."[8]

Trade and Capital Flows Reforms

Since July 1991, the government has introduced a series of reforms in the trade sector which are aimed to help integration of the Indian economy better with the rest of the world. ***Among these reform measures, devaluation of rupee in July 1991 and subsequently its depreciation against the currencies of the leading industrialised countries, introduction of the convertibility of the rupee first on trade account and then for the entire current account transactions, liberalisation of import regime, substantial reduction in customs tariff rates, decanalisation of many items of trade and wide ranging measures to give a thrust to exports are important.***

The system of fixed exchange rates was abandoned by India in September 1975 and since then the system of managed exchange rate float has been in operation. Under the new system the rupee was not expected to appreciate against other currencies, causing a decline in the international competitiveness of the Indian exports. However, due to higher rate of inflation in India as compared to that in the developed countries, the real effective exchange rate of rupee did not fall as much as the nominal effective exchange rate of the rupee. Hence, as already written earlier, ***the government formally devalued rupee by 18-19 per cent in July 1991 to restore India's international competitiveness.*** This was followed by a liberalisation of the foreign trade regime through dismantling of some physical controls. Not only the import procedures were simplified, a significant number of items were also shifted outside the purview of import licensing.

As a first step towards a gradual reduction in the tariffs, the 1991-92 Budget had reduced the peak rate of import duty from more than 300 per cent to 150 per cent. The process of lowering the customs tariff rate was carried further in subsequent Budgets. ***The 1995-96 Budget reduced the peak rate of import duty from 65 per cent to 50 per cent. This was reduced to 40 per cent in the 1997-98 Budget, 12.5 per cent in the 2006-07 Budget and further to 10 per cent in the 2007-08 Budget.***

Over the past few years, not only substantial import duty cuts have been made in the case of machine tools, steel ores and concentrates, leather industry, electronics and telecommunications sectors, but the ***prevailing system of import duties has also been considerably rationalised*** with the purpose of establishing a parity in prices of goods produced domestically and internationally.

Earlier, a large number of exports and imports used to be canalised through public sector agencies. During the last two decades, ***a large number of export and import items have been decanalised.*** Decanalisation of imports and exports is an important step towards opening of more areas of the external sector to the private sector. The government has also introduced a number of export promotion measures in recent years. These include establishment of Export Oriented Units for promoting exports from the agricultural and allied sectors, simplification of Export Promotion Capital Goods Scheme, introduction of Export Promotion Capital Goods Scheme for the services sector, adoption of a more rational and convenient criterion for recognition of export houses/ Trading houses/Star Trading houses, broadening of areas of activity in Export Processing Zones, duty free import for exports under the advance licensing scheme, setting up of Special Economic Zones (SEZs), and creation of an exporters' grievance cell in the Ministry of Commerce to facilitate action on problems being faced by exporters. Besides these, some more schemes/measures have been introduced to

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accelerate the country's transition to a globally-oriented economy, to stimulate growth by providing access to capital goods, intermediates and raw materials, and to enhance technological strengths of the economy thereby improving the global competitiveness of Indian exports.

The government has also liberalised capital flows in the form of foreign direct investment (FDI) as a part of the package of external sector reforms. Foreign companies are now allowed to use their trade marks, accept appointment as technical or management advisers, borrow and accept deposits from the public and repatriate profits etc.

Industrial Deregulation

Historically, ***India's domestic economic activities have been subject to a wide array of physical controls. In the industrial sector, such controls took various forms: industrial licensing which regulated entry and expansion; reservation of a large number of industries for the public sector as well as small-scale sector; time-consuming procedure required for the exit of industrial units; and price and distribution controls on various industrial products.*** Jagdish Bhagwati and Padma Desai have been highly critical of this regulatory system.[9] Isher J. Ahluwalia also blamed the industrial licensing system and bureaucratic controls for the industrial stagnation during the second half of the 1960s and the 1970s.[10] The long time taken by the industrial licensing authorities to give clearance to the various proposals made it impossible for any project of importance to be completed within the scheduled time period. The industrial licensing authorities often took exception to the attempts of the industrial units to produce more than licensed capacity. Thus, the objective of maximisation of output from a given licensed capacity got undermined. Moreover, the industrial licensing system as it had evolved over the years had become a major source of political and bureaucratic corruption and was being used by powerful vested interests to throttle competition.

Limit on the size of the companies which was earlier enforced under the Monopoly and Restrictive Trade Practices Act has now been scrapped. This will allow industrial units to grow to optimum size and enjoy the benefits of economies of scale. The anti-monopoly legislation until this relaxation was made, had prevented many firms from growing to optimum size and thus achieve higher efficiency levels. The industrial location policy has been both simplified and liberalised. The phased manufacturing programme under which domestic manufacturers were required to increase the domestic input-content of their products in a specified period has also been abolished under the new industrial policy. It is widely believed that these relaxations of the regulatory apparatus governing the industrial activity in this country in the past have considerably eased the entry barriers which should make the industrial sector more competitive both domestically and internationally. However, a major limitation of the structural reform in the industrial sector is that it has failed to evolve appropriate rules and procedures regarding exit of inviable industrial units. The existing industrial exit policy is highly restrictive and time-consuming. This is one factor which has led to widespread industrial sickness.

It is widely believed that the regulatory mechanism had led to widespread inefficiency in the industrial sector. The government had, therefore, relaxed some of the industrial controls even before it committed itself to structural reforms in 1991. The thrust of the new industrial policy announced in July 1991 has been on deregulation of the industrial economy in a substantial manner and opening up a large number of industries to the private sector. ***The requirement of industrial licensing has been abolished for all but 5 product categories.*** These are alcohol, cigarettes, hazardous chemicals, industrial explosives and electronics aeroscape and defence equipment (all types).

In another significant step, the number of industries reserved for the public sector has been reduced from 17 to 2. Now core industries like iron and steel, electricity, air transport, shipbuilding, heavy machinery etc. and even strategic industry like defence production have been opened up for the private sector.

Public Sector Reforms and Disinvestment

The public sector was originally intended to be the engine of self-sustained economic growth. It was also conceived to hold the commanding heights of the economy and to lead to technological advance. In order to fulfil these roles, it was necessary for the public sector to generate adequate investible surpluses. No doubt public sector contributed significantly to the expansion of the industrial base. Its role in diversifying the industrial structure has been no less. However, it has failed to generate sufficient internal resources for its further expansion and, as a result, has now become a major constraint on economic growth. Under structural reforms, the government has decided to give greater managerial autonomy to public enterprises to enable them to work efficiently. In addition to this, two other key elements of the government's strategy for public enterprise reform are the promotion of increased private sector competition in areas where social considerations are not paramount and partial divestment of equity in selected enterprises.

Equity amounting to ₹ 2,47,383 crore in public sector undertakings was disinvested to public sector financial institutions, mutual funds, private corporates and general

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public till end-March 2017. Total resources raised through disinvestment in 2017-18 and 2018-19 amounted to ₹ 1,00,057 crore and ₹ 84,974 crore respectively. Initially, the government had talked of disposing off burdensome loss-making PSUs while well performing PSUs were to be given autonomy to enable them to develop as global Indian multinational corporations. However, there is virtually no evidence of any such initiative in practice. ***The government policy seems to be entirely limited to selling off shares of prime PSUs with the aim of bridging budget deficits.***

Financial Sector Reforms

A vibrant, efficient and competitive financial system is necessary to support the structural reforms in the real economy. As pointed out by the Tenth Five Year Plan, ***"An important outcome of financial sector reforms is that it contributes to greater flexibility in the factor and product markets. With the real sector becoming increasingly market driven and engulfed by a competitive environment there is need for a matching and dynamic response from the financial sector."***[11] This is possible only if the productivity and efficiency of the financial system improves. Keeping this in view, the government set up Committee on the Financial System in 1991 and on Banking Sector Reforms in 1998 (Narasimham Committees).

The Committee on Financial System was asked to examine the country's financial system and its various components and to make recommendations in respect of the following:

1. For improving the efficiency and effectiveness of the Financial System, with special reference to economy of operations, accountability and profitability.

2. For infusing greater competition into the financial system so as to enable the banks and other financial institutions to respond more effectively to the credit needs of the economy.

3. For ensuring appropriate and effective supervision over the various entities in the financial sector, in particular the commercial banks and term lending institutions.

The Committee was also required to review the existing legislative framework and to suggest necessary amendments for implementing the recommendations.

The report of the Narasimham Committee on Financial System was placed before the Parliament in December 1991, and since then it has become a basis for introducing reforms in the banking sector. The major reform measures undertaken during the past few years are as follows:

1. The levels of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) were progressively raised during the 1980s for combating inflationary pressures generated by large budgetary deficits. This, however, adversely affected the profitability of banks and pressurised them to charge high interest rates on their commercial sector advances. ***The government has over the years brought down both statutory liquidity ratio and cash reserve ratio in a phased manner.*** The effective statutory liquidity ratio was lowered down to 24 per cent with effect from November 8, 2008. It was raised to 25.0 per cent in November 2009 but again brought down to 24.0 per cent on December 18, 2010. ***It now stands at 18.75 per cent.*** The cash reserve ratio was also brought down to 4.5 per cent with effect from June 14, 2003. Thereafter, it was raised in stages to check the liquidity overhang in the system and stood at 9 per cent on August 30, 2008. However, because of economic slowdown in later period, CRR has been reduced in phases to increase liquidity in the system. ***The final reduction came on February 9, 2013 when CRR was reduced to 4.0 per cent.***

2. The RBI introduced new prudential norms in respect of income recognition, classification of assets, provisioning of bad debts and capital adequacy. The minimum capital standards were prescribed in accordance with the Basel Committee norms under which banks were required to maintain unimpaired capital funds equivalent to 8 per cent of the aggregate of the risk-weighted assets. Banks were expected to touch 8 per cent capital to risk-weighted asset ratio (CRAR) by March 1996. Foreign banks operating in India and Indian banks operating abroad were, however, required to attain 8 per cent by March 1993 and March 1994 respectively. The CRAR was raised from 8 per cent to 9 per cent from the year ended March 2000. CRAR for commercial banks at end-March 2017 stood at 13.6 per cent. ***Now all banks groups have CRAR much higher than the minimum 9 per cent stipulated by the Reserve Bank of India.***

3. Commercial banks attaining capital adequacy norms and prudential accounting standards had a freedom to set up new branches without the approval of the Reserve Bank of India. Banks can now also had to rationalise their existing branch network by relocating branches, opening of specialised branches, setting up controlling offices etc.

4. The RBI has announced guidelines for setting up banks in the private sector. These banks should be financially viable and should avoid concentration of credit and cross holdings with industrial groups. Further, they will have to observe priority sector lending targets as applicable to other banks.

5. Number of interest rates slabs on banks advances were reduced from about 20 in 1989-90 to 2 in the financial year 1994-95. This attempt to unify interest rate structure aims at reducing the degree of cross-subsidy in the banking system. Moreover, interest rates in the banking system

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have been liberalised, compared to the situation prevailing before 1991. According to Montek S. Ahluwalia, ***"The rationale for liberalising interest rates in the banking system was to allow banks greater flexibility and encourage competition."***[12]

6. The supervisory system of the RBI has been strengthened with the establishment of a new Board for Financial Supervision under the chairmanship of a Deputy Governor of the RBI. The Board ensures implementation of the regulations with respect to credit management, asset classification, income recognition, provisioning, capital adequacy and treasury operations.

7. Agreements between the RBI and public sector banks have been made to improve the management and the quality of the performance of the latter. This includes management information system and the internal audit and control mechanisms.

8. Recovery of debts due to banks and other financial institutions in the past has been unsatisfactory. Hence, an Act was passed in 1993 under which Special Recovery Tribunals have been set up to facilitate quicker recovery of loan arrears.

9. The guidelines for determining the maximum permissible bank finance have been made more flexible. Banks will now have greater freedom in determining the working capital needs of the borrowers and responding to local requirements in an appropriate manner.

Following the recommendations of the Narasimham Committee on Financial System the above reform measures were undertaken. Meanwhile, major changes had taken place in the domestic economic and institutional scene. Also, there was a movement towards global integration of financial services. Under the circumstances banking system had to be stronger and better equipped to compete effectively in a fast changing economic environment. The government thus appointed the Committee on Banking Sector Reforms under the Chairmanship of M. Narasimham. The Committee submitted its report in April 1998. Its major recommendations are as follows:

1. Strong banks should be merged and relatively weak and unviable ones should be closed. Mergers between banks and development financial institutions may be considered if it makes economic and commercial sense.
2. The country should have two or three banks with international orientation, eight to ten national banks and a large number of local banks. The third tier banks should remain confined to smaller geographical regions. The first and second tier banks should take care of the needs of the corporate sector.
3. The Committee recommended new and higher norms for capital adequacy. It suggested that the minimum Capital to Risk-weighted Assets Ratio (CRAR) be increased to 10 per cent from its earlier level of 8 per cent.
4. Budgetary support for recapitalisation is not viable and should thus be abandoned.
5. Legal framework is not adequate for credit recovery. It should be strengthened.
6. Net non-performing assets for all banks be brought down to below 5 per cent by the year 2000 and to 3 per cent by 2002.
7. There should be rationalisation of branches and staff.
8. Bank boards should be depoliticised under the RBI supervision.
9. The policy of licensing new private sector banks may be continued.
10. Foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks.
11. There has to be an integrated system of regulation and supervision to regulate and supervise the activities of banks, financial institutions and non-bank finance companies. The agency for this purpose be renamed as the Board for Financial Regulation and Supervision (BFRS).

The second half of the 1990s saw the dangers associated with the mindless liberalisation in the financial sector world over. Incidents like those of the Barings Bank and the bank failures during the South-East Asian crisis exposed the problems which arose from inadequate regulation and supervision of banks. Hence, ***the Committee on Banking Sector Reforms under the Chairmanship of M. Narasimham particularly stressed on prudential measures like the increase in the Capital to Risk-weighted Assets Ratio (CRAR), the introduction of market risk on government securities, the stricter Non-Performing Assets (NPAs) norms and provisioning requirements and the introduction of asset-liability management guidelines, and risk management guidelines.***

In line with these recommendations of the Second Narasimham Committee, a gamut of measures to strengthen the banking system have been announced. Important measures from this point of view are: ***raising the CRAR to 9 per cent, strengthening prudential accounting norms, laying down Asset Liability Management (ALM) and Risk Management guidelines and directing the banks to provide***

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additional information in the 'Notes to Accounts' in the balance sheets to increase transparency. In 2002, Securitisation, Reconstruction of Financial Assets and Enforcement of Security Act was passed in order to provide a satisfactory legal framework for the recovery of bank credit.

AN APPRAISAL OF ECONOMIC REFORMS

Nobody denies the fact that the Indian economy has witnessed a fast rate of growth during the period of economic reforms. However, there are contrasting views on whether this growth has enabled the country to tackle the problems of poverty and inequality and whether it has enabled the country to improve its performance on various social indicators (particularly those pertaining to health and education). While Jagdish Bhagwati and Arvind Panagariya in their book *India's Tryst with Destiny: Debunking Myths that Undermine Progress and Addressing New Challenges* (published in late 2012) have argued that growth in the reform period has actually delivered in the above respects, Jean Dreze and Amartya Sen in their book *An Uncertain Glory: India and its Contradictions* (published in July 2013) have argued that it has not. Thus, the two books take opposite positions and a lot of articles on this issue and interviews of the two great economists of India Jagdish Bhagwati and Amartya Sen have appeared in the Press in recent times giving rise to what has been termed ***'Bhagwati vs. Sen debate'*** (reigniting, in the process, the age-old debate in Economics on 'growth vs. distribution').

1. Higher growth in the reform period. The period of economic reforms has witnessed significant growth. The rate of growth of GDP which was 3.4 per cent per annum during the 1960s and 1970s and 5.2 per cent per annum in 1980s rose to 5.9 per cent per annum in 1990s and further to as high as 7.6 per cent per annum in the first decade of the present century. Correspondingly, the rate of growth of per capita GDP also increased substantially and was as high as 6.0 per cent per annum in the first decade of the present century.[13] GDP growth at constant prices (base year 2011-12) was 7.2 per cent in 2017-18 and 6.8 per cent in 2018-19. In fact, during some of the recent years, the Indian economy was the fastest growing economy among the major economies of the world.

2. Low rate of increase in average per capita expenditure and real wages. In support of this contention, Dreze and Sen point to the following facts.[14] While the fast growth of the economy in the post-reform period has led to an improvement in the living standard of the middle classes (which tends to mean the top 20 per cent or so of the population by income), the impact of reforms on the poor people has been negligible and there is hardly any change in their abysmal living conditions.

(*i*) According to NSS data, average per capita expenditure in rural areas rose at the exceedingly low rate of only about 1 per cent per year between 1993-94 and 2009-10, and even in urban areas, average per capita expenditure grew at only 2 per cent per year in this period. The corresponding growth rates of per capita expenditure for poor households in both areas would have been even lower, since there was growing inequality of per capita expenditures in that period.

(*ii*) There has been a major slowdown in the growth of real agricultural wages in the post-reform period: from about 5 per cent per annum in the 1980s to 2 per cent per annum or so in the 1990s and virtually zero in the early 2000s (the rate of growth in real agricultural wages for men was a meagre 0.1 per cent per annum over the period 2000-01 to 2005-06 while wages for women actually fell). It was only after the initiation of MGNREGS in 2006 that real wages picked up again.

(*iii*) The growth of real wages in other parts of the economy has also been relatively slow, especially for casual and unskilled workers. According to comparable international data from the ILO, while real wages in manufacturing in China increased at a robust rate of 12 per cent per annum or so in the first decade of the present century, they increased by only 2.5 per cent per annum in India. Many independent studies also corroborate the fact that real wages in China have been rising rapidly over the last 20 to 30 years. In India, by contrast, the growth rate of real wages has been much lower than that of per capita GDP over the same period. As a result of this, ***there has been a steep decline in the share of wages in value added*** (it may be pointed out here that increase in the share of wages in value added is a sure indicator of the spread of economic progress in a country).

The above facts seem to be at considerable variance with the official estimates of poverty put forward by the Planning Commission from time to time. According to these estimates, the proportion of the rural population below the poverty line declined from about 50 per cent in 1993-94 to about 34 per cent in 2009-10 and further to about 26 per cent in 2011-12. This looks like a big improvement. The question is: how do we reconcile the fact that the growth of real per capita expenditure has been so low? One is the unreliability of the estimates depicting sharp fall in rural poverty levels (see the sub-section 'Poverty Estimates Based

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on 68th Round of NSSO' in Chapter 15 on 'Poverty in India'). The other is what Dreze and Sen call the 'density fact': "the fact that many people are just a little below the official poverty line, so that a small increase in per capita expenditure is enough to 'lift' them above the line."[15]

3. Jobless growth. As explained in detail in Chapter 12 on 'Employment and Unemployment in India', the period of economic reforms has witnessed the phenomenon of jobless growth — the growth rate has accelerated but jobs have failed to increase. Not only this. ***Even the quality of existing jobs deteriorated, with the percentage of workers in the informal sector increasing.*** Strangely, this was also the case in the organised sector, where quality of work is generally better. In the last 10 years alone, the percentage of contract workers without social security increased from 19 per cent to 32 per cent in the organised industrial sector. So, if those who are participating in growth, are not benefiting, who is?[16]

4. Growing inequalities. The period of economic reforms has witnessed growing income inequalities. According to the *World Development Indicators* 2017, while the lowest 10 per cent households accounted for only 3.6 per cent of the aggregate household expenditure in India in 2011, the share of top 10 per cent was as large as 29.8 per cent. In fact, inequalities have increased considerably in recent years. This would be clear from the fact that ***the share of the top 1 per cent in the country's wealth rose from 40.3 per cent in 2010 to 58.4 per cent in 2016.*** Over the same period, the share of the top 10 per cent in the country's wealth increased from 68.8 per cent to 80.7 per cent. ***The plight of the poor would be clear from the fact that the bottom half of the population owned a mere 2.1 per cent of the country's wealth in 2016.***[17]

5. Poor living conditions in major States. Table 3.8 of Dreze and Sen's book clearly brings out the fact that seven major States (with a combined population of 545 million in 2011, about half of India's population) have had poor social indicators for a long time, as well as high levels of poverty: Bihar, Chattisgarh, Jharkhand, Madhya Pradesh, Odisha, Rajasthan and Uttar Pradesh. Data presented in the Table suggest that less than half of all children aged 8-11 years are able to pass a very simple reading test in some of these States, only 23 per cent of young children are fully immunized in Uttar Pradesh, and more than half of Bihar's population lives below the poverty line. In international perspective, some of these States are not very different from the poor countries of Africa in intensity of human deprivation. In terms of MPI (multidimensional poverty index), these seven States are more or less on a par — taken together — with the 27 poorest countries of Africa, and have roughly the same population. Multidimensional poverty figures suggest that ***living conditions in the poorer half of India are not much better, if at all, than in the poorer half of Africa.***[18]

6. Neglect of education and healthcare. The economic reforms focused on macroeconomic stabilisation and structural reforms. They completely neglected education and healthcare. These are two fields which do not interest the private sector and the State cannot abdicate its responsibility for providing them. As pointed out by Amartya Sen, "'Marketisation' in some areas is not a very good way of running things. Say in the case of healthcare, it will never be. At some level, education could be quite efficient, provided it is not just for profit. But at an elementary level, I don't see the market doing that work".[19]

There has been a glaring failure of the government on education and health fronts. The Annual Status of Education Report (ASER) for the year 2017 shows that the quality of learning has either shown no improvement or has actually declined over the years 2005 to 2016 (the first ASER was published in 2005). For example, the proportion of all children in Class 5 who can read a Class 2 level text declined from 61.3 per cent in 2005 to 47.8 per cent in 2016. This means that every other student is unable to read something meant for some one three classes below. The children fared no better in Mathematics or English comprehension. For example, the ability of Class 8 students to divide has further declined. The proportion of all Class 8 students in rural India who can divide a three-digit number by a single-digit has dipped to 43.2 per cent in 2016 from 44.2 per cent in 2014. And while 32 per cent of children in Class 3 could read simple English words in 2016, up by 3.5 percentage points over 2009, in Class 5, only one out of every four students could read an English sentence. ASER (2017) underlines that this situation has remained unchanged since 2009, when the Right to Education (RTE) was passed by Parliament.

As far as public expenditure on health is concerned, it is just 1.1 per cent of GDP in India — only 9 countries in the world have a lower ratio of public expenditure on health than in India. A related symptom of Indian government's lack of commitment to healthcare is that public expenditure on health accounts for less than one-third of total health expenditure. Only a few countries (such as Bangladesh, Cambodia, Haiti, Mali, Nigeria and Sierra Leone) have a lower ratio of public expenditure to total health expenditure. The world average is 60.1 per cent, and even the averages for Sub-Saharan Africa (42.6 per cent) and for the 'least developed countries' in the world (42.4 per cent) are also much higher than India's 30 per cent.[20] Not only this. Health facilities in most of the public health centres are poor. To illustrate, only 69 per cent of Primary Health Centres (PHCs) had at least one bed, only 20 per cent had

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a telephone, and just 12 per cent enjoyed 'regular maintenance'. These are national averages and the corresponding figures for the poorer States are much worse. There are thousands of PHCs and dispensaries that function largely on paper. Many of these have not seen a doctor for months, even years in some cases.[21]

As pointed out by Montek Singh Ahluwalia, "faster progress in both education and health is not only critical for improving the welfare of the bulk of the population, it is also critical for economic expansion. ***No country has been able to achieve rapid growth of GDP for an extended period without raising the levels of education and health of the bulk of the population to reasonable levels.***[22] Efforts are required in two different dimensions: *(i)* increasing the expenditure of both Centre and States on education and health by at least 3 percentage points of GDP over the next five years; and *(ii)* substantial improvements in the governments' capacities to ensure that increased expenditure actually delivers results. Since the delivery of these services is the responsibility of State and local government functionaries, most of the improvement in delivery systems has to be orchestrated at that level.[23]

7. Widespread malnutrition and undernutrition. As brought out clearly in Chapter 24 'Agricultural Subsidies and Food Security in India', there is widespread prevalence of malnutrition and undernutrition in India. India's hunger index score for 2017 is 31.4 which is indicative of a 'serious' situation. One in every seven persons was undernourished in this country during 2014-16. Moreover, as many as 38.4 per cent of children under five were stunted (low height-for-age) and 21.0 per cent were wasted (low weight-for-height) during 2012-16. In fact, the period of economic reforms has witnessed very little improvement in nutrition indicators. Nutrition intakes (calorie, protein, micronutrients — almost anything except fat) have decreased. As pointed out by Dreze and Sen, "While there is much scope for debate about different ways of measuring undernourishment, what is not in doubt is that ***India still has a higher proportion of undernourished children than almost any other country in the world,*** even after thirty years of rapid economic growth. Many countries have been able to achieve big improvements in the health and nutrition status of their respective populations in a shorter time, even with lower rates of economic growth."[24]

The above discussion clearly brings out the fact that rapid economic growth in the economic reforms period has failed to improve the living condition of the masses. In fact, evidence of growth bypassing the poor and the excluded is increasing by the day. Be it nutrition, sanitation, educational enrolment, learning achievements, or status of women, we continue to remain at the bottom of world rankings. Economists who focus only on growth (like Jagdish Bhagwati and Arvind Panagariya) are right when they argue that it is through growth only that required revenues can be generated to undertake economic and social development programmes. However, their belief that the benefits of growth automatically trickle down is not correct as the above facts and analysis accompany them clearly bring out. The fact is that those who argue for larger social expenditure programmes do not oppose growth *per se* but view it as a means of achieving a larger objective. For instance, note the following statement of Dreze and Sen, "Economic growth is indeed important, not for itself, but for what it allows a country to do with the resources that are generated, expanding both individual incomes and the public revenue that can be used to meet social commitments."[25] Growth in itself is meaningless 'if' it is not accompanied by improvements in incomes for the majority.

8. The question of sustainability of growth. Although being one of the staunchest supporters of faster growth, Montek Singh Ahluwalia questions its sustainability as it is bound to generate *environmental stress.* This includes: (*i*) erosion of forest cover because of felling of trees; (*ii*) pollution of natural waterbodies such as lakes and rivers because of dumping of untreated sewage, industrial effluents and run-off of fertilizers and pesticides; (*iii*) local air pollution due to burning of fossil fuels and other unsupervised incineration of municipal waste, along with crop residues, and construction activity without precautions to prevent spread of particulate matter; (*iv*) traffic congestion in cities due to inadequate transport planning and absence of public transport; (*v*) increase in soil salinity from excessive watering and fertilization; (*vi*) accumulation of municipal solid waste in urban areas and unscientific methods of waste disposal; and (*vii*) emissions of greenhouse gases into the atmosphere because of burning of fossil fuels, leading to global warming.

Of the seven negative consequences listed above, only the last is a global problem. All the other six are essentially local problems and there is no excuse for not taking appropriate action on these fronts. However, nothing much has been done so far on these fronts with the result that ***"whether we look at forest cover, water quality or air quality, the situation is actually deteriorating."***[26]

NOTES

1. Deepak Nayyar, "Indian Economy at the Crossroads — Illusions and Realities", *Economic and Political Weekly*, April 10, 1993, p. 639.
2. *Ibid.*, p. 640.

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3. Arvind Panagariya, *India: The Emerging Giant* (New Delhi, 2008), p. 99.
4. *Ibid.*, p. 103.
5. According to Montek Singh Ahluwalia, while controls began to be 'moderated' in the first half of 1980s by Prime Minister Indira Gandhi and 'aggressively' in the second half of 1980s by Prime Minister Rajiv Gandhi, ***"the policy changes, though important were not endemic. They introduced flexibility at the margin but left the control system itself in place, liable to reversal at any time".*** It were the policy measures introduced in 1991 that marked a complete break from the past. See Montek Singh Ahluwalia, "India's 1991 Reforms: A Retrospective Overview", in Rakesh Mohan (ed.), *India Transformed: 25 Years of Economic Reforms* (New Delhi, 2017), p. 48.
6. Vijay Joshi and I.M.D. Little, "Macroeconomic Stabilisation in India, 1991-1993 and Beyond", *Economic and Political Weekly*, December 4, 1993, p. 2659.
7. Government of India, Planning Commission, *Eighth Five Year Plan* 1992-97, Volume I (Delhi, 1992), p. 94.
8. Montek Singh Ahluwalia, *op. cit.*, p. 48.
9. Jagdish N. Bhagwati and Padma Desai, *India: Planning for Industrialisation* (London, 1970), p. 499.
10. Isher Judge Ahluwalia, *Industrial Growth in India — Stagnation since the Mid-sixties* (Delhi, 1985), p. 163.
11. Government of India, Planning Commission, *Tenth Five Year Plan* 2002-07, Volume I (Delhi, 2003), pp. 63-4.
12. Montek S. Ahluwalia, "Reforming India's Financial Sector: An Overview", in James A. Hanson and Sanjay Kathuria (ed.), *India's Financial Sector in the Twenty-first Century* (New Delhi, 1999), p. 33.
13. Jean Dreze and Amartya Sen, *An Uncertain Glory: India and Its Contradictions* (New Delhi, 2013), Table 2.1, p. 23.
14. *Ibid.*, pp. 29-30.
15. *Ibid.*, p. 30.
16. Himanshu, "Growth versus Redistribution", *Mint*, July 19, 2013, p. 9.
17. World Bank, *World Development Indicators* 2016 (Washington DC, 2016), Table 2.9 and *Mint*, November 23, 2016, p. 4.
18. Dreze and Sen, *op. cit.*, pp. 75-7.
19. Interview with Amartya Sen published in *Mint*, July 24, 2013, p. 21.
20. Dreze and Sen, *op. cit.*, p. 149.
21. P. Sainath, *Everybody Loves a Good Drought* (New Delhi, 1996), p. 25. The entire chapter 'The Trickle Up and Down theory' (pp. 23-44) is worth reading. It gives a chilling account of the deplorable state of healthcare in India's poorest districts.
22. Montek Singh Ahluwalia, *op. cit.*, p. 64.
23. *Ibid.*, p. 65.
24. Dreze and Sen, *op. cit.*, p. 33.
25. *Ibid.*, p. 18.
26. Montek Singh Ahluwalia, *op. cit.*, pp. 65-66.

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