UNIT 1 NATIONAL INCOME AND THE ECONOMY

Structure

1.0 OBJECTIVES

This unit aims to familiarise you with basic features of an economy and the main indicators about its performance.

After going through this lesson you would be able to:

- explain the concept of an economy;
- define national income, discuss its relevance to the study of various aspects of the economy, and describe its various uses; and
- list some fundamental questions about an economy, and the welfare and standard of living of its people.

1.1 INTRODUCTION

Of what relevance is the study of national income in the context of an economy? This is what the unit attempts to answer. Before we make such an attempt, it is necessary that we first familiarise ourselves with, and understand the concepts of, national income and the economy. The two concepts are now frequently used by most governments in their economic policy statements. We will first explain the meaning of an economy.

1.2 MEANING OF AN ECONOMY

The term "economy" has many dimensions. It may refer to a region of a country, the entire country itself or the whole world. For example, we can talk about Haryana's economy, the Indian economy, the Asian economy, the European economy or the World economy. In this unit we will confine the dimensions of an economy to a country.

An economy of a country refers to the economic aspects of a country. And what are these economic activities? Production, consumption and investment are the three basic economic activities the residents of a country perform. As such, a study of an economy is the study of production, consumption and investment taking place in that economy.

Production activities are carried out in farms, in factories, shops, banks, hospitals, schools, colleges, railways, airlines, ships, government offices, charitable institutions, and so on. All these are called production units.

Consumption activities are carried out at homes and by the government. At homes it is carried out by households who spend on food, clothing, housing, furniture, electrical appliances, etc. The main motive is the satisfaction of wants of the members of the family. The government spends on consumption on behalf of the people. It buys goods and services from production units to provide services, which are sometimes free, to people. Government spends on hospitals, schools, colleges, police, military, legislatures and other public utility services to the people. Purchases for consumption both by households and governments are made from production units.

Investment activities are undertaken in production units. All purchases of goods like machines, buildings, furniture, etc. and expenditure on keeping stocks of raw materials, semi-finished and finished goods, etc. during a year are expenditure on investments. Any expenditure that adds to capital assets of a production unit is treated as investment. These purchases are also made from production units.

A study of production, consumption and investment activities carried out by people and institution in a country is the study of economy of that country.

Conceptually, a distinction is made between a closed economy and an open economy. A closed economy is one which has no economic relations with the rest of the world. It is closed to the rest of the world. An open economy is one which has economic relations with the rest of the world. It is open to the rest of the world. Indian economy is an open economy. India is engaged in exports, imports, borrowing, lending, etc activities with other countries. Like India, nearly all the economies of the world are open economies. At present, it is difficult to find an example of a closed economy.

1.3 MEANING OF NATIONAL INCOME

National income of a country is the sum of incomes earned by its residents from the factor services rendered to the production units both within and outside the geographical boundaries of the country.

The term 'national' here refers to 'of residents' and the term income refers to

'factor income'. The two terms are explained in detail in Unit - 4. Here we will explain these terms in brief.

The term "residents" refers to those individuals (and institutions) whose economic interest lies in the country in which they live (or located). By economic interest we mean the basic economic activities of production, consumption and investment Thus, Mr. A may or may not be the citizen of India but so long as his economic interest lies in India he is treated as Indian resident. You must have heard the term "Non-Resident Indian (NRI)". Why are they called 'non-resident' and 'Indian'? They are called Indians because they are Indian citizens and not of the country in which they live. They are called non-resident because they are not the residents of India but of the country in which they live because their economic interest does not lie in India.

Factor incomes refer to the incomes derived by those who provide factor service to production units. Land (natural resources), labour (human resources), capital (man-made resources) and enterprenuership are the four factors of production. A production unit, in order to produce goods and services, employs these factors of production. A payment made to a factor of production for the services rendered is called **factor payment**. The owners of land get rent, labour gets wages or salaries, capital gets interest and the entrepreneur gets profit. The sum total of these factor incomes derived by the residents of a country is the national income of that country. In the technical language of national income accounting national income is called Net National Products at Factor Cost. This and other related aggregates woven around the concept of national income are explained in Unit -4. The scope of this unit is limited to just making you familiar with the concept of national income.

We go a step further and also make you familiar with the three ways of looking at national income. Incomes are first created in production units through the activity of producing goods and services. The owners of the factors of production then receive their shares. This is called the income of the factors of production. The recipients of these factor incomes spend the income on buying goods and services from production units. As such the creation, distribution and spending of income are respectively known as the Production, Income distribution and Expenditure angles of looking at the flow of national income. These are also respectively referred to as the Production, Income-distribution and Expenditure methods of measuring national income. In fact these are simply the three sources of data to obtain the same information (i.e. national income).

The three angles though aims at the same aggregate, i.e. national income, each one is significant in its own way in revealing the structure of economy. The production angle reveals the contribution of different production units, or groups of production units. The production units are commonly grouped into Primary Secondary and Territary Sectors. The terms Primary, Secondary and Tertiary and explained in Unit -4. The income-distribution angle reveals the distribution of incomes among different groups of factor owners like labour class, property class, entrepreneurial class, and land owning class. The expenditure approach reveals the purchases of goods and services produced by the production units. How much is bought for consumption and investment. Consumption expenditure is commonly classified into private and government. Investment expenditure is usually classified into domestic and foreign. Domestic investment is the investment within the economic territory of a country and is termed as

Gross Domestic Capital Formation. The term investment (in an aggregate macroeconomic sense) means addition to the capital stock, with capital in this context denoting machinery and instruments of production. Foreign investment is given by net exports (=Exports-Imports).

Check Your Progress 1

1) What do you understand by "resident" in the context of an economy?

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2) Name the four factors of production and the respective payments made to them.

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3) Describe in two sentences the information that expenditure method of estimating national income reveals.

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1.4 QUESTIONS ABOUT AN ECONOMY THAT INTEREST US

Laypersons may be interested in knowing about many things regarding an economy, but merely by observing what is happening around, they may not be in a position to obtain the answers to many of these questions. They may get some hints but not the definite answers. One has to look towards data to get some meaningful answers. Before we move further let us note some of the questions that interest us about an economy.

1) Is the economy growing ?
2) Are all parts of the economy growing ?
3) Are people getting more goods and services?
4) Are all sections of the people benefiting from growth?
5) Is the standard of living of the people rising?
6) What is the future of the economy?
7) How rich (or poor) is the economy in comparison to other economies of the world?

8) Is government spending enough on welfare programmes?

9) How should funds be allocated?

There may be many other questions, but we have confined ourselves to only some general questions that may interest a student of economics. The clues to all the above mentioned questions can be found in the huge amount of data collected in the process of estimating national income. We now take the above questions one by one and see their relation with national income data.

1.4.1 Is the Economy Growing?

You must have heard about the term "economic growth" often in economic news on radio, TV, etc. The news may be that India's rate of economic growth is so and so percent. Do you know that this rate of economic growth is nothing but the rate of growth of national income (at constant prices)? Suppose, for illustration, that National Income at constant Prices of a country during the years 2003 and 2004 is respectively Rs. 1000 crores and Rs. 1060 crores. It means that during the year 2004 National Income at Constant Prices increased by Rs. 60 crores. The rate of growth is calculated as follows :

$$\text{Rate of growth} = \frac{\textit{Change in National Income at constant prices during a year}}{\textit{National Income at Constant prices during the previous year}} \times 100$$

$$= \frac{60 \times 100}{1000} = 6\%$$

The above 6% rise in the National Income at Constant Prices is the rate of growth of the country during a given year.

You were made familiar with the concept of national income above. But what is this 'constant prices' attached to it ? This concept is explained in detail in Unit 4. Here it would suffice to say that National Income at Constant Prices is a measure of increase in the net availability of physical goods and services, or an index of physical production. Thus, an increase in National Income at Constant Prices indicates increase in physical production of goods and services in the country.

1.4.2 Are All Parts of the Economy Growing ?

Occupationwise an economy is broadly divided into primary, secondary and tertiary sectors. Primary sector includes production units producing goods by exploiting natural resources. Some examples are farming, mining, fishing, animal husbandry, etc. Most of such economic activities are usually carried out in rural areas. The secondary sector includes production units engaged in transforming goods from one form into another. Some examples are production of bicycles, scooters, and television. Most of these activities are carried out in a factory or mill. The tertiary sector includes units producing only services like banks, transport shops, insurance government department, domestic servants, etc.

Relative comparison of performance of these sectors in the field of production and contribution to national income is the point of interest both for government and people. An unusual fall in the contribution of a sector alarms the government

because the performances of these sectors is dependent on each other. For example, if agricultural production is low supply of raw materials to the secondary sector will also be low and consequently the production. As a result the demand for services is also likely to be low. So if agriculture suffers, other sectors suffer too. The government may then have to import raw materials and food from abroad and spend valuable foreign exchange. If the secondary sector's production is low, the primary sector is also likely to suffer in terms of low demand for raw materials.

From the above it is clear that all parts of economy should grow. However, growth of a sector should not be confused with the share of a sector in the national income. For example, for development it is necessary for the agricultural sector to grow, but it is also broadly true that over the course of a nation's development over time, the share of agriculture in the national income falls, while that of the secondary and tertiary sectors grow. Data obtained in the process of estimating national income through the production method can supply the required information about the various sectors of the economy.

1.4.3 Are People Getting More Goods and Services?

Every country want that its people should get more goods and services every year. The measure that is used to find out if this is actually happening is Per Capita Income (of course at constant prices). Per capita income equals total national income divided by total population (you will occasionally come across the term *per caput.* This means the same thing as per capita, which means 'per head')

$$\text{Per Capita Income} = \frac{\textit{National Income}}{\textit{Population}}$$

Per capita income measures average availability of goods and services to an individual during a given year. If per capita income rises it means that on an average people are getting more goods and services. It is sign of betterment of people and every government will like to take credit for the same.

It is not necessary that when national income rises per capita income also rises. It is possible that the rate of growth of population may be faster than the rate of growth of national income. In this situation per capita income falls even though national income rises. This happened in India in the year 1976-77 when national income rose by 0.9 percent while per capita income fell by 1.3 percent because population grew at a rate of 2.2 per cent which was higher than the rate of growth of national income. Thus there may be more reason to be satisfied if per capita income rise rather than only national income rises.

1.4.4 Is Growth Benefiting All Sections of the Population?

National income may rise but may not necessarily benefit sections of the society, or *equally* benefit all sections. Let us take an illustration based on imaginary data. Suppose the economy is divided into rural and urban sectors. Suppose the following is known about the relative contribution of these sectors to national income during the years 2003 and 2004. (Table 1).

Year	Rural	Urban Sector	Economy
1	2	3	4
2003	80	120	200
2004	75	135	210
Rate of growth	(-) 6.25%	+12.5%	+5%

The table shows that national income increased by 5%. It is also reveals that rate for growth of national income in rural area is negative. National income originating in the rural sector fell by 6.25% while that in urban sector increased by 12.5%. It implies that all sections of the people have not benefited from growth of the economy. This is a cause of worry both to government and people. It means that there are inequalities in income in the society.

The data about the distribution of income among different sections of the economy can be obtained when national income is estimated through the income distribution approach.

Is rural sector benefited along with urban sector? Is corporate sector benefited more than the non-corporate sector ? Are all regions of an economy benefited from economic growth ? These and a variety of similar questions bother politicians, policy makers, analysis. etc.

One special point of interest for any government is the share of Labour class in national income. The Labour class is always in majority in a country. Denying this class its due share in economic growth may lead to many political, social and economic problems in the country. No country can afford to invite Labour unrest. So if the government finds that there is fall in the share of labour in national income it can take suitable measures to correct the same like raising minimum wage, relief in taxes, etc. The data about the share of labour in national income can be directly obtained through the income distribution method of estimating national income**.**

Check Your Progress 2

1) Choose the correct alternative.

   The rate of growth of a country is the same as the rate of growth of

   a) National income at current prices

   b) National income at constant prices

   c) Investment at current prices

   d) Investment at constant prices

2) Choose the correct alternative.

   Fisheries are a part of

   a) Primary sector

b) Secondary sector

c) Tertiary sector

d) None of the above

3) How do we know that on an average people are getting more goods and services every year ?

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1.4.5 Is the Standard of Living of the People Rising?

It is one economic aspect in which people in general are interested in and make comments quite often about the same when they chat with each other. " We hardly had things earlier. Now we have them in plenty. Earlier, each one had normally two pairs of shoes. Now many people have many pairs of shoes. "Such comments are quite common in personal talks. These comments show how keenly people observe the general standard of living.

Standard of living of a family is determined by what that family spends on satisfaction of wants. Similarly the standard of living of the people of a country as a whole is determined by what people spend on consumer goods and services. If we divide total consumption expenditure in the country by total population we can get a measure of average standard of living. A suitable comparison of per capita consumption expenditures can tell us whether the average standard of living of the people is rising and at what rate ?

The expenditure approach to the measurement of national income gives the relevant data on the above point of interest. In this method total expenditure of the country is classified into consumption and investment expenditures. Consumption expenditure is further classified into private and government consumption expenditures. Private consumption expenditure is incurred by households. Government consumption expenditure is incurred by government on providing free services to the people. Both these expenditure affect the standard of living of the people. Every government will like to see that general standard of the people is rising. A detailed examination of data on consumption expenditure can also be helpful in determine the standard of living of the different sectors of the society. Such an examination can be very helpful in taking policy measures regarding different sections of the society.

1.4.6 What is the Future of the Economy?

We all make provisions out of current income to make our future secure. In other words, we save out of current income and invest these savings in financial instruments to earn more income in future years. In the same way the society as a whole saves and invests. The investments so done lead to bigger flow of goods and services in the future. More the investments the more the flow, and the higher the standard of living of the society in future is likely to be.

The expenditure approach of estimating national incomes requires the collection of data on saving and investments in the country. Investment within the economic territory of the country is termed as Domestic Capital Formation . Investment outside the country is termed net exports (equal to exports minus imports). The two investments taken together determine largely what is in store in future for the society. This is why every government lays so much emphasis on fresh investments in the country.

1.4.7 How Rich (or Poor) is The Economy ?

It is a relative question and can be answered only by comparing the national income of the given economy with national incomes of other economies. Nearly all countries of the world estimate their incomes. By comparing our economy's income with the incomes of the other countries we can know, how much rich or poor our economy is in relation to foreign economies.

For example, the per capita national incomes of India and USA in the year 1994 were respectively 320 and 25,880 US dollars. A simple comparison of these figures reveals that an average an American was earning 80 times that of an Indian. However this comparison is rather vague. Average price level is much higher in USA as compared to that in India. It means that a U.S. dollar spent in USA will get less goods and services as compared to the same US dollar spent in India. But such differences in price levels can be eliminated with the help of suitable price index numbers. The figures so obtained after adjusting for differences in price levels provide some meaningful data to make a comparison between two countries. We can, not only make comparison of income levels but we can also make comparisons of consumption expenditure, investments, government expenditures.

In the context of the world, we can make use of national data of different countries to any extent. Suppose an international project involving several countries is to be undertaken. The expenditure on this project can be shared according to the income levels of these countries.

1.4.8 Is Government Spending Enough on Welfare Activities?

It is basic duty of every government to maintain law and order, to guard the country from foreign attacks, to provide certain basic facilities like water supply, education, medical facilities, roads, etc. For this purpose government incurs expenditure on lice, courts, military, sanitation, schools, colleges, roads, hospitals, etc. More the expenditure more the facilities. Every government would like to take credit on this point. The expenditure method of estimating national income helps in collecting data on these needs. This variable is called Government Final Consumption Expenditure, and is a measure of the value of free services rendered to the people.

1.4.9 How Should Funds be Allocated ?

Such decisions are normally taken by the planning commission, or any other alternative bodies appointed by the government. The problem is clearly of allocation of funds. It is difficult exercise full of technical problems. It is just not allocating this much for one and that much for the other sector. While allocating funds to an individual sector its technological dependence on other sector must have to be kept in mind. In allocating funds to the agricultural

sector its dependence on producers of chemical fertilisers, pesticides, water pumps, generator sets, tractors, transporters, etc. must be kept in mind. So if funds are allocated to agriculture and if no funds are allocated to the supporting sectors the targets may not be achieved.

For the funds allocation exercise it is necessary to know (a) from whom the given industrial sector buys inputs and (b) to whom it sells its output. This technological information about all the industrial sectors of the economy is summarized in an account called 'Input-output accounting matrix'. It is prepared from the detailed data made available in the process of estimating national income through the various methods. Such an account reveals the production functions of industrial sectors of an economy and can serve as a useful guide to Planning Commission or similar government bodies.

Check Your Progress 3

1) Choose the correct alternative.

   Which of the following indicates standard of living of the people of a country?

   a) National income

   b) Investment expenditure

   c) Consumption expenditure

   d) None of the above

2) Choose the correct alternative

   Information on investment is obtained in the process of estimating national income by

   a) Production method

   b) Income distribution method

   c) Expenditure method

   d) All the three methods

3) How do you know from national income data that government is spending enough on welfare of the people?

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4) How is national income data helpful in allocation of funds among different industrial sectors?

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UNIT 4 CONCEPT AND MEASUREMENT OF NATIONAL INCOME

Structure

4.0 OBJECTIVES

This unit aims at discussing various methods of estimating national income and related aggregates. For that the unit discusses the basic concepts that are used in defining and distinguishing among various aggregate measures of economic activity.

After going through this Unit you would be able to:

- explain the meaning of economic territory;
- define a resident unit;
- define the term ‘factor income’;
- explain the meaning of national income at constant price;
- describe the production, income, and expenditure methods of estimating national income; and
- explain the considerations involved in choosing a method.

4.1 INTRODUCTION

In the three earlier units, you have been acquainted with the meaning of national income, the circular flow of income in an economy, the basic concepts of consumption, saving and investment, and also with production— both intermediate and final — and finally, with value added. In this unit we take a closer and more detailed look at what constitutes national income and what the concept means. National income of a country equals the sum total of factor incomes accruing to the residents of economic territory of that country. This meaning of national income requires familiarity with at least three terms: (1) Economic territory, (2) Residents, (3) Factor incomes. Let us explain these terms.

4.2 SOME BASIC CONCEPTS

4.2.1 Economic Territory

You must be familiar with the term geographical territory that is defined strictly on the basis of political boundaries of a country. Economic territory is derived from physical territory but on economic basis. It crosses marginally the political frontiers of a country. In nutshell, the concept of economic territory is carved out of geographical territory by adding some portions of the rest of the world and by subtracting some portions of geographical territory. This addition and subtraction is made strictly on the basis of some well defined economic criterion. We are taking here the criterion laid down in the System of National Accounts (SNA) developed by the United Nations. We will have occasion to study the SNA in greater detail a little ahead in the course.

According to the SNA, the economic territory of a country consists of geographical territory administrated by a government within which persons, goods and capital circulate freely. It includes: (a) the airspace, territorial waters, and continental shelf lying in the international waters over which the country enjoys exclusive rights; (b) territorial enclaves in the rest of the world such as embassies, consultants, military basis, etc. and (c) any free zones, or bonded warehouses or factories operated by offshore enterprises under customs control. It does not include (a) territorial enclaves used by foreign governments such as foreign embassies, foreign consultants, etc. and (b) international organizations.

The implications of the above can be explained with the help of an illustration. To take an example, consider the British High Commission in New Delhi. It is taken as part of British Economic Territory. All economic activities of the British High Commission are taken to be taking place in the economic territory of Britain and are accounted for in the Britain's GDP. Similarly all economic activities of Indian embassy in Washington are accounted for as part of India's GDP.

4.2.2 Resident

The term resident is different from the term citizen. Citizenship of a country is linked with birth or some other non-economic criterion. The term 'resident' on the other hand is linked strictly with economic criterion. Accounting to SNA, a resident unit is one whose center of economic interest lies in the

economic territory of the country in question. This unit may be an individual, a household, a government, a corporation, a non-profit institution etc.

By centre of economic interest is meant that the institutional unit is located within economic territory and carries out its economic activities and transactions on a significant scale over a long period of time from that location. As a working arrangement the term 'long period of time' is usually taken to mean a period of one year or more. On the basis the travellers or visitors who leave economic territory for less than one year continue to be resident of that economic territory. Similarly, workers working outside economic territory for a part of the year, border workers, locally recruited staff in international originations, in foreign embassies, staff working in ships, aircrafts etc operating on international routes are all residents. For example, an Indian resident working in British embassy remains Indian resident. A Briton posted in New Delhi office of the British Airways remains the British resident. The time period rule does not apply to students studying abroad, medical patients abroad even if they stay for more than one a year in foreign countries.

In SNA, the ownership of land and structure with the economic territory of a country is deemed to be sufficient in itself for the owner to have a center of economic interest in that country. Along with this the SNA has adopted the convention that all land and structures are owned by residents, actual or national. Let us explain the meaning of the term 'notional'. If a non-resident owns a building, the owner is treated as if he transferred his ownership to a notional institutional unit which is actually resident in that country. In this sense all production units within the economic territory are resident production units. But the factor services supplied to these units need not necessarily be supplied by the residents only. Non-residents may also supply factor services and claim in return the factor income. Similarly residents may also supply factor services to production units outside the economic territory and claim factor income in return.

The overall conclusion is simple. First, all factor payments (wages, rents, interest, profits, etc.) by the resident production units need not necessarily be made to the residents only. A part may be made to non-residents. Second, all factor incomes received by the residents need not necessarily be received from production units within the economic territory only but may be received also from outside the economic territory.

4.2.3 Factor Income

Conventionally, factors of production are classified into four groups viz. labour, land, capital and entrepreneurship. Labour includes all types of mental and physical efforts involved in production. Land includes all natural resources. Capital includes all physical assets used in production. The entrepreneurship implies the risk taking ability of the owners of production units.

The owners of factors of production sell their services, called factor services, to the production units. In turn, production units make payment for these services. These payments are called factor payments. These payments are termed as compensation of employees, rent, interest and profits. These are made respectively to the owners of labour, land, financial assets and entrepreneurship. The exact meaning and components of these factor payments are explained in section 4.3.4 below. These payments are the factor payments

or factor costs from the angle of production units but factor incomes to the owners of factors of production. In this way factor costs and factor incomes are same in national income accounting.

Broadly thus a factor income is the income received by a factor owner from rendering services to the production unit. Labour receives compensation of employees, i.e. wages, salaries, etc. Land owner receives rent. Capital owner, i.e. the one who provides finance, receives interest. The entrepreneurship, who is the owner of production unit, receives profit.

The sum total of factor payments made by resident production units of an economy territory is termed domestic income or technically, net domestic product at factor cost. The sum total of factor incomes received by the residents of an economic territory, both from with the economic territory and from the rest of the world, is called national income, or technically, **Net National Product at factor cost**.

4.2.4 Intermediate Consumption

We can explain this concept with the help of an example. A farmer producing grain buys seeds, fertilizers, power, water, pesticides, etc. from other production units. These inputs are entirely used up in the process of production and transformed into grain during the year. The consumption of such inputs in the process of production is termed as intermediate consumption. SNA defines intermediate consumption as the value of goods and services that are entirely used up in the course of production during the accounting period.

To classify the use of a good or service as intermediate consumption, two conditions must be fulfilled. First, it is purchased or acquired by a production unit from another production unit. Second, it is acquired for resale which amounts to being used up entirely in the course of production during the accounting period. For example, milk purchased by a restaurant, cloth purchased by a garment manufacturer, petrol purchased by a taxi driver, bricks purchased by a construction company, expenditure on repairs by a production unit, etc. are all intermediate consumption. Goods and services acquired for intermediate consumption are called intermediate products. Expenditure on intermediate products is called intermediate cost. This intermediate cost is a part of the price of the product produced from these.

4.2.5 Final Product

The concept of final product is opposite of the concept of intermediate product. Intermediate products are identified on the basis of 'resale' criterion. Final products are identified on the basis of 'not for resale' criterion. Goods and services acquired not for resale but for own use, are final products. When one acquires a good or a service for own use, the good or service in question is said to reach its final use. It implies that it is no more required to be processed or treaded further.

When a consumer acquires a good or a service, she acquires it for consumption, or to be more precise, for final consumption. When a production unit acquires a good, not for resale, it acquires the same for investment. For example, purchase of a machine for use in production by production unit is an investment (but purchase of raw materials is intermediate consumption). We can now

conveniently define final products. Goods and services acquired for final consumption and investment (and not for resale) are final products. For example, milk purchased by a household, cloth purchased by a household, motor vehicle purchased by a taxi driver, crane purchased by a construction company, refrigerator purchased by a restaurant are all final products.

4.2.6 Value Added

The concept has been explained in detail in Unit 3 section 3.8. Value added, gross value added at market price (GVA_{mp}) to be more specific, equals the excess of value of gross output over intermediate costs. The specific measures of value added are:

GVA_{mp} = Value of gross output minus Intermediate cost

NVA_{mp} (net value added at market prices) = GVA_{mp} minus Consumption of fixed capital

NVA_{fc} (net value added at factor cost) = NVA_{mp} minus Indirect taxes plus Subsidies

The above measures relate to one production unit. By summing up value added by all the production units located within an economic territory, we get different measures of domestic products.

ΣGVA_{mp} (where " denotes summation) = GDP_{mp} .

$\Sigma NVA_{mp} = NDP_{mp}$

$\Sigma NVA_{fc} = NDP_{fc}$

By adding net factor income received from abroad (NFIA) to the above measures we get measures of national product.

$GDP_{mp} + NFIA = GNP_{mp}$

$NDP_{mp} + NFIA = NNP_{mp}$

$NDP_{fc} + NFIA = NNP_{fc}$

NNP_{fc} is what we call national income. Our purpose in this lesson is to explain the different methods of estimating national income.

4.2.7 National Income at Constant Prices

Let us first try to understand the purpose behind introducing this concept. We try to understand the same first at micro level. Suppose an individual was earning money incomes of Rs,10,000 and Rs,20,000, respectively in the years 1995and 2005. It means that during the ten years the individual's money income has doubled. Further suppose that during this ten years period the average prices of goods and services he consumed also doubled. Where does this individual stand in 2005 as compared to 1995? What happened to his real position over these years? Since both money income and price level have doubled, the individual gets the same quantity of goods and services in 2005 as he got in 1995. It means that there is no change in his real income position with respect to the availability of goods and services. This real position is nothing but his real income. Over the 10 year period the individual's money

income doubled while his real income remained the same. So which is better, money income or real income, for comparing the performance of the individual? Clearly, real income is better. Money income may give a false picture. Money income and real income at the macro level are more appropriate termed as 'current prices' and 'constant prices' estimates of national income, respectively. For comparing the national income performance of the economy over the years only the constant price estimates are relevant.

Why do we call real income estimates as constant price estimates? National income from the production angle is a measure which is derived from the value of final products. The value of final products equals 'price x quantity' or 'PQ' . Therefore $\Sigma P_{95}Q_{95}$ and $\Sigma P_{2005}Q_{2005}$ would represent the national incomes of the year 1995 and 2005 respectively. Since these values are derived with the help of current year's prices (i.e. 1995 income at 1995 prices and 2005 income at 2005 prices), these measures are termed as current price measures. The two years are strictly not comparable because of the element of price change. To compare 1995 with 2005 we require both years national income to be expressed either at the prices of 1995 or at the prices of 2005. At the prices of 1995 it would mean $\Sigma P_{95}Q_{95}$ and $\Sigma P_{95}Q_{95}$. At the prices of 2005 it would mean $\Sigma P_{05}Q_{05}$ and $\Sigma P_{05}Q_{05}$. Such measures is called constant price measure because in this each year's national income is expressed at some single year's price.

There is a simple method of expressing current price estimates into constant price estimates. The entire exercise is known as the process of deflation. The technique used is that of price index number. There are many theoretical issues involved in applying this technique. We will not go into these issues. We will only describe the method.

Quantity wise and price wise different goods and services have different importance in national income. So, weighted price index, instead of un-weighted, is used to deflate national income. The simple most formula is:

$$\text{Constant Price Estimates} = \frac{\text{Current price estimates}}{\text{Current Year Price Index}} \times \text{Base year price index}$$

Example

Suppose following is known about an economy.

Year	National Income at Current Prices (Rs.crores)	Price Index
1995	1000	100
2005	2000	160

$$\text{2005 Constant Price Estimates} = \frac{\text{2005 Current Price Estimates}}{\text{2005 Price Index}} \times \text{Base Year's Price Index}$$

$$= \frac{2000}{160} \times 100$$

$$= \text{Rs.1250 crores}$$

Constant price estimate reveals that national income in real terms rose only by 25% (from 1000 to 1250). On the other hand current price estimates had indicated that national income rose by 100% (from 1000 to 2000). Thus current price estimate gives an inflated picture while the constant price estimate gives the real picture.

Check Your Progress 1

1) Who is called a resident unit?

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2) Tick the correct alternative.

Economic territory of a country:

a) Is same as geographical territory.

b) Is derived after subtracting some portions from geographical territory.

c) Is derived after adding some potions to geographical territory.

d) Is derived after adding and subtracting some portion to and from geographical territory.

3) Define intermediate consumption.

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4) A good or service is treated as a final product when acquired for :

a) For consumption only

b) For investment only

c) Both for consumption and investment

d) Neither for consumption nor for investment

4.3 METHODS OF ESTIMATING NATIONAL INCOME

4.3.1 Origin

Our aim is to estimate national income. It is defined as sum total of factor incomes accruing to the residents of economic territory of a country. From where do we get data about the same? We can get answer to this if we first answer these questions. Where are factor income generated? Who generates factor income? On what are incomes spent?

Factor incomes are generated in production units. These are generated by the factor owners hired by the production units. Factor owners in turn get factor incomes from production units. When we estimate national income by collecting data at the generation stage, the entire process of estimation is termed as production method. When we collect data when factor incomes are distributed among the factor owners, the process is termed as income – distribution method. When the data are collected, when income are being spent, the process is termed as expenditure method. Conventionally thus there are three methods of estimation national income.

4.3.2 Classification of Production Units

There are innumerable production units in the economic territory of a country. For example, in a big country like India, we find millions of units: big and small factories, shops, service centers, service institutions, etc. Is it really feasible to get data adequate enough to estimate value added by each individual production unit separately? What is normally done in practical estimates is to first classify all the production units into some convenient number of sectors and then make an estimate of national income originating in each sector separately, and then take the sum of sectoral value added to arrive at GDP.

All production units of similar type are grouped into one sector. For example, all production units engaged in raising crops are grouped as agriculture sector. All banking institutions are grouped as banking sector. All factories are grouped as manufacturing sector and so on. On this basis, the production units located on India's economic territory are classified into the following sectors:

1) Agriculture and allied activities
2) Forestry and logging
3) Fishing
4) Mining and quarrying
5) Manufacturing
6) Construction
7) Electricity, gas and water supply
8) Trade, hotels and restaurants
9) Transport, storage and communication
10) Banking and insurance
11) Real Estates, ownership of dwellings and business services
12) Public administration and Defence
13) Other Service

Irrespective of the method one adopts, the classification of production units into convenient number of sectors, called industrial sectors, is the first exercise required to be undertaken. We now turn our attention to explain the steps required to be taken in estimating national income by different methods.

4.3.3 Production (or value added) Method

When, to estimate national income, data are obtained at the income creation stage, the exercise is termed as production method (or value added method). The method involves the following steps:

1) Classify production units into some convenient numbers of industrial sectors. Each sector should contain similar type of production units as far as possible. (This step has been explained in detail in section 4.3.2).

2) Estimate NVA_{fc} by each industrial sector

   NVA_{fc} by a sector can be obtained by taking the following sub-steps:

   1) Estimate value of gross output: The same can be obtained (a) as sum of sales and net change in inventories or (b) as quantity of output multiplied by price.

   2) Estimate intermediate cost and deduct the same from the value of gross output to obtain GVA_{mp}.

   3) Estimate consumption of fixed capital and subtract the same from GVA_{mp} to arrive at NVA_{mp}.

   4) Subtract indirect taxes from and add subsidies to NVA_{mp} to arrive at NVA_{fc}. All taxes on production such as excise duty, sale tax, octroi, custom duties, license fees etc. are indirect taxes. The estimate so arrived gives the contribution of the sector to national income.

Take the sum of NVA_{fc} of all industrial sectors of the economic territory. This sum equal NDP_{fc} at current prices.

Add net factor income from Abroad to NDP_{fc}. This gives us an estimate of NNP_{fc} or national income at current prices.

Deflate current price national income into constant price national income. The process of deflation was explained in sector 4.2.7. By doing so, we arrive at an estimate of real national income. This enables us to compare the performance of national income of given year with the previous year.

While taking the above steps there are certain things which must be kept in view. First, only newly produced goods and services must be counted. Sale and purchase of second- hand goods should not be treated as production. Second, transactions in financial assets like shares and debentures are not counted. However, any service charge or brokerage paid as payment for the service rendered and is included in production. Third, goods and services produced for own use, must be counted. For example, grain produced by farmer but used for family consumption, building one's own house, cooking one's food and son on. It is different thing that the estimators may sometimes find it difficult to include these goods and services because no estimate of their value can be made.

Now let us discuss the methods.

4.3.4 Income Distribution Method

Income paid out versus. Income received variants

Factor incomes are paid out by production units and received by factor owners. So we can get data about factor incomes either from the records of production units, or from the records of factor owners. Accordingly there are two variants of the methods: (i) income paid out and (ii) income received.

Income-paid-out variant

Factor incomes are paid out by production units in the form of compensation of employees, rent, interest and profits. Before we describe the required steps let us first explain the meaning of the individual factor income.

i) **Compensation of employees (COE)**

SNA defines COE as the total remuneration, in cash or in kind, payable by an enterprise to an employee in return for work done by the latter during the accounting period. It has two main components: (a) wages and salaries in cash or in kind and (b) social contributions payable by the employers.

Cash payments includes regular periodic payments like monthly salary, allowances, bonus, compensations, etc. related to the amount of work done by the employees. Wages and salaries in kind consist of consumption good or service provided as remuneration by the employee like meals, housing, clothing, vehicles including goods and services produced and provided free by the employers.

Social contributions include contributions, actual or imputed incurred by employers in order to obtain social benefits for their employees. Actual social contributions include payment by employers to social security funds, insurance companies, pension funds, etc. Imputed social contributions include social benefits provided by the employers directly to their employees without involving specialized institutions like insurance companies etc. for the same.

ii) **Rent**

Rent is the amount payable by the tenant to the landlord. It may be paid in cash, or in kind as in agriculture. The entire amount payable as rent is not factor income. A part of this may be payable by landlord as tax. Another part of rent may be incurred as maintenance expenses. The 'net rent' after deducting tax payable and maintenance changes is factor income.

Royalty payments on granting the leasing rights of subsoil assets in the form of deposit of minerals like coal, oil or natural gas, are also treated as rents.

It should be kept in mind here with payments made for the use of buildings or other structure is not rent but rental. Very often rent payable on building covers both rent of land and rental of structures. Only that part of such payable which is rent of land should be counted as factor payment. (Rental of structure is simply payment for services offered by the owner of structure and is intermediate cost for the production units and final consumption expenditure for the consumers).

iii) **Interest**

Interest is amount actual or imputed payable by production units on the financial assets provided by the creditors including the funds provided by the owner. It is the amount payable on the liabilities of enterprise. It is recorded on accrual basis. Only interest payable on loans taken for the purpose of production are treated as factor payments. Interest payable on loans taken for meeting consumption expenditure is not a factor payment because such a loan is not used as a factor of production

iv) **Profit**

Profit is the factor income accruing to the entrepreneur. It is also called entrepreneurial income broadly. It is normally divided into three parts: (a) profit tax (b) distributed profits i.e. dividends, etc. and (c) retained profits (or undistributed profits).

Concept of Operating Surplus (or mixed income)

Operating surplus and mixed income are two alternatives names for the same item. The difference is that Operating surplus relates to 'Corporate and quasi-corporate' group of enterprise. Mixed income relates to non-corporate enterprises. It is defined as:

Operating Surplus = NVA_{mp}

(or mixed income) Compensation of Employees (COE)

- Indirect Taxes

- Subsidies

In brief, operating surplus (or mixed income) equals the sum of rent, interest profits.

A distinction is made between gross and net operating surplus. The above concept is 'net' Gross operating surplus equals net operating surplus plus consumption of fixed capital. Alternatively, it is sum of rent, interest, profit and consumption of fixed capital.

National Income

In terms of income paid out variant, the sum total of COE, rent, interest, profits, or that of COE and operating surplus or (mixed income), paid out by resident production units located in economic territory equals NDP_{fc}. By adding net factor income received from abroad (NFIA) to NDP_{fc} we get a measure of NNP_{fc} or simply national income

Steps in estimation

The following steps are required to be taken for estimating national income by the income paid out variant. Most steps are same as in case of production method.

1) Classify production units into a convenient number of industrial sectors.

2) Estimate factor payments made by each sector. The factor payments are in the form of COE, rent, interest and profits; or in the form of COE,

operating surplus and mixed income. The sum total of these factor payments equals NVA_{fc}.

3) Take sum of NVA_{fc} by all sectors to obtain the measure of NDP_{fc}.

4) Add NFIA to NDP_{fc} to obtain NNP_{fc} i.e. national income at current prices.

5) Deflate national income by using appropriate index numbers.

4.3.5 Expenditure Method

Expenditure method measures national income at the disposition stage. Disposition here means disposition of income or final products. In this way it has two variants: income disposal and product disposal. Income disposal variant classifies expenditure into consumption expenditure and savings. Product disposal variant classifies expenditure on final products as expenditure on consumption and investment. This is way it is also called final products method. In actual practice, product disposal variant is used because of the comparatively easy position of the availability of data. As such we will explain the product disposal variant in detail.

Expenditure method (product disposal variant) estimates national expenditure by disposition of final products. This method attempts to answer the question: who buys final products? Resident, consumers, resident investors, or non-residents?

The uses of final products, for the purpose of estimating national income, are usually classified into four groups : (1) Private final consumption expenditure (PFCE), (2) Government final consumption expenditure (GFCE) (3) Gross Domestic Capital Formation (GDFC) and (4) Net Exports. The first two are consumption uses and last two investment uses (1) The sum of C and I gives GDP_{mp}. Let us now explain the meaning of each component.

i) **Private Final Consumption Expenditure (PFCE)**

PFCE is further subdivided into: (a) Households Final Consumption Expenditure (HFCE) and (b) Non-Profit Institutions serving households final consumption expenditure (NPISHCE).

a) HFCE

It consists of expenditure, both actual and imputed, incurred by resident households on consumption goods and services, whether that expenditure is incurred within the economic territory or abroad. Expenditure by residents abroad constitutes imports. So HFCE has an element of import. It does not constitute entirely of final products produced within economic territory.

b) NPISH-FCE

It consists of imputed expenditure incurred by the resident NPISHs on providing free services of households. Imputed expenditure means actual expenditure incurred on providing services (like COE, intermediate consumption, CFC etc.) less sales (like token price, fees etc.).

The sum total of HFCE and NPISH FCE is called PFCE.

ii) **Government Final Consumption Expenditure (GFCE)**

It consists of imputed expenditures, incurred by general government. Incurred on providing services like COE, intermediate consumption, CFC etc. less receipts from sales (like token fees, price, etc.).

iii) **Gross Capital Formation (GCF)**

GCF represents addition to the stock of capital during an accounting period. It consists of (a) value of gross fixed capital formation (GFCF) and (b) changes in inventories. 9SNA 1993 also includes acquisition of valuables like precious stones and metals, painting, jewelry, etc. in GCF).

GFCF is measured by net acquisition (i.e. acquisition less disposals of tangible and intangible assets during the accounting period. Main types of tangible fixed assets are dwelling; other buildings and structures; machinery and equipment; cultivated assets like trees and livestock. Main types of intangible fixed assets are mineral exploration; computer software; entertainment, literary or artistic originals, etc. Expenditure on improvements of fixed assets is also included in GFCF.

Change in inventory equals the value of the net acquisition (Acquisition less disposal) of the inventories acquired by enterprises during the accounting period. Inventories consists of materials and supplies, work in progress, goods for resale and finished goods. Materials and supplies consists of goods meant for intermediate consumption. Work in progress consists of output produced by an enterprise that is not yet finished. Goods for resale are goods acquired by enterprises such as wholesalers or retailers, for the purpose of reselling.

GCF, also called gross domestic capital formation (GDCF) in India equals expenditure on investment by the residents during the accounting period.

iv) **Net exports**

Net exports equal exports less imports of goods and services. Exports consist of sales, barter, gifts or grants from resident to non-resident. Net exports is value of sale of final products to non-residents.

Steps in estimation

1) Classify production units into distinct industrial sectors.

2) Estimate final expenditures incurred in the output produced by different sectors.

3) Take the sum of final expenditures on the output of all the industrial sectors to obtain GDPmp.

PFCE (= HFCE + NPISH FCE)

\+ GFCE

\+ GDCF (=GDFCF + Net changes in inventories)

\+ Net exports (=Exports – Imports)

= GDPmp

4) Subtract consumption of fixed capital and net indirect taxes from GDPmp to get NDPfc.

5) Add NFIA to NDPfc to get NNPfc (i.e. national Income) at current prices.

6) Deflate final expenditures by using appropriate indexes to obtain national income at constant prices.

The exercise of identifying final expenditures must be undertaken with great care. Many precautions are necessary. First, intermediate expenditures must be carefully identified and ignored. Second, only expenditures on goods and services are to be counted. Expenditures on financial assets like that on shares, debentures etc. are not to be included. Third, expenditures on gifts, donations, taxes, fines etc. are transfer expenditures and not final expenditures. Fourth, expenditures on second hand goods are not to be included. Only expenditure on newly produced goods and services produced during the accounting period is to be included.

4.4 CHOICE OF METHOD

We have seen that there are three methods of estimating national income. Should national income be estimated from all the three methods simultaneously? If only one method is to be chosen, which one? What determines the choice? The choice, in practice, is determined by two main considerations. What is the purpose? What types of data are actually available?

i) **Purpose**

Each method serves a different purpose. Production method, by measuring values added by a sector, reveals the contribution of different industrial sectors to national income. Such an information is extremely useful in planning allocation of resources.

Income method reveals as to how much equally or unequally is national income distributed. This information is useful in planning the reduction of inequalities.

Expenditure method, by measuring consumption and investment expenditure reveals the standard of living of the people. Distribution of consumption expenditure reveals standard of living of different groups. Investment expenditure indicates the potential of raising the standard of living in the future.

ii) **Data Position**

The data availability position is more important than the purpose of estimation. It is a big constraint. Planners may have a particular purpose of national income in mind, but if the relevant data are not available, what one can do. So many times, in practical world, the purpose has to be sidelined in the absence of required data. National Income is estimated with the help of the method about which data can be conveniently collected. In Indian estimates, for example, data position is so acute that so far it has not been possible to apply a single method to all the sectors. Different methods have been sued for different sectors.

The ideal position for any economy would be to estimate national income originating from each individual sector of the economy by all the three methods simultaneously to extract maximum out of national income data.

Check Your Progress 2

1) What is the basis of the three methods of estimating national income?

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2) Name the two variants of the income distribution method. What is their meaning?

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3) Name the two variants of the expenditure method. What is their meaning?

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4) What is the purpose of estimating national income through the production method?

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4.5 LET US SUM UP

National income is the sum of factor incomes accruing to the residents of an economic territory during an accounting year. Economic territory consists of geographical territory administrated by government within which persons, goods and capital circulate freely. A resident unit is one whose center of economic interest lies in the economic territory of the country in question. A factor income is the income received by a factor owner from rendering services to the production unit. These are in the form of COE, rent, interest and profits.

Intermediate consumption is the value of goods and services that are entirely used up in the course of production during the accounting period. It consists of all goods and services acquired by one production unit from other production units and meant for resale, directly or indirectly. Final products ae those which are acquired for consumption and investment and not for resale. Excess of value of output over the intermediate consumption is termed as value added or

to be more precisely GVAmp. Sum total of GVAmp of all the resident production units equals GDPmp. By subtracting consumption of fixed capital and net indirect axes from and adding NFIA, we get NNPfc (or national income).

Constant price estimation of national income is a measure of real income. It is derived by dividing current price estimate by the price index. The entire process of derivation is called deflation.

Factor incomes are generated in production units; distributed to the factor owners; and disposed of on consumption and saving (or investment). Accordingly there are three sources of data, i.e. accounts of production units, of factor owners and data on expenditures, for obtaining information on national income. This had resulted in three methods, production, income and expenditure methods of estimating national income.

The first step, irrespective of the method used, is to classify production units into a convenient number of industrial sectors. The second step differs from method to method. In production method, we measure value added; in income method, factor payments; and in expenditure method, expenditures incurred on final products. The third step is to take sum of all these variables of all sectors. This step is summarised as below:

Production Method	Income Method	Expenditure Method
Σ GVAmp		PFCE
-CFC	COE	+GFCE
-Net indirect Tax	+Rent	+GDCF
	+Interest	+NET exports
	+Profits	-CFC
		-Net Indirect axes
=NDPfc	=NDPfc	=NDPfc

The fourth step is to add NFIA to NDPfc to get NNPfc or national income at current prices. The fifth step is to deflate current price estimates into constant price estimates by using index numbers.

The choice of method, in actual estimates, is determined by (i) the purpose at hand and (ii) availability of data. The purpose of production method is to measure the contribution of industrial sectors to national income. Income method measures equitableness of distribution of income. Expenditure method measures standard of living of the different groups in the society. Depending on the data position, the estimators have to many a time compromise with the purpose at hand.

4.6 KEY WORDS

Compensation of employees : Total remuneration, in cash of in kind, ayable by an enterprise to an employee in return for work done.

Deflation : The process of converting current price estimates into constant price estimates.

Economic territory	:	Consists of geographical territory administrated by a government within which persons, goods and capital circulate freely.
Factor income	:	Income received by a factor owner by rendering services to a production unit.
Final Products	:	Goods and services acquired for final consumption and investment.
Gross Capital Formation	:	Sum of gross fixed capital formation and changes in inventories
Household final consumption	:	Expenditure, both actual and imputed, incurred by resident households on consumption goods and services within expenditure economic territory and abroad
Intermediate Consumption	:	Value of goods and services that are entirely used up in course of production during accounting period.
Mixed Income	:	Excess of NVAfc over the COE in case of non-corporate enterprise.
Operating Surplus	:	Excess of NVAfc over the COE in case of corporate and quasi-corporate enterprises.
Rent	:	The amount payable, in cash or in kind, by tenant to the landlord for land including royalty payments on the sub-soil assets.
Resident unit	:	One whose center of economic interest lies in the economic territory in question.
Social Contribution	:	Contribution incurred by employers in order to obtain social benefits for their employees.

4.7 SOME USEFUL BOOKS

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UNIT 8 APPLICATIONS OF NATIONAL INCOME ACCOUNTS

Structure

8.0 OBJECTIVES

After going through the units, you will be able to:

- explain the use of national accounts in measuring standard of living;
- describe the process of comparison of national income across time and space;
- discuss the use of national income accounts for policy purposes and planning; and
- analyse the use of a database of the economy in studying relationships among macro-variables in the economy

8.1 INTRODUCTION

There are several important uses of the estimates of national income and related aggregates. These uses vary from validation of basic data to the complex analytical issues relating to policy formulation. National income estimates not only provide a single figure but also provide supply estimates by broad sectors of the economy. The aggregate as well as sector-wise estimates of national income throw light on the functioning of the economy. Because of the importance of the estimates, CSO in India has been preparing and publishing the estimates since 1956. Over period of time the extent of the coverage has been enlarged, the data base as well as the methodology has improved. In this

unit we discuss some of the important uses of the estimates of national income and its related aggregates like consumption and investment.

8.2 APPLICATIONS

8.2.1 Measure of Standard of Living

The estimates of national income and per capita income (derived by dividing the total national income by the population) give us an average income and standard of living of the people. Economic welfare depends to a considerable degree on the level of national income and its distribution. Therefore, to know about the level of economic welfare it is essential to have estimates of national and per capita income.

Here it may be mentioned that there are certain problems in taking per capita income as the only measure of standard of living or that of development of the economy. The per capita income may be high even when only a few people are very rich and a vast majority of people are poor. The process of economic development is a complex phenomenon and is influenced by many factors. If the income of a vast majority of people are low but free health and educational services are provided, the standard of the people will be better than if no free services are provided. Also the well being of the people depends on the composition of the output. If luxuries are being produced in relatively greater quantities than necessaries, there will be shortage of goods for the poor people.

Nowadays in addition to national income, a number of development indicators are being suggested for evaluating standard of living or development. Growth in national income is possible without development, but for development growth is essential.

8.2.2 Comparison Across Time and Space

By comparing national income over a period of time we can know whether the economy is growing or not. If national income increases over years, it means the economy is growing and if national income is falling, it indicates that the economy is declining.

For having meaningful comparison of national income over time the effect of change in prices has to be removed. If the money value of national income of an economy is increasing by 2% every year and if the prices are also increasing by 2%, then there is no real growth in the economy and it is stagnant. The comparison of the estimate of national income over time can be done only in real terms i.e. if the estimates are prepared at constant prices. Because of this reason, the CSO is preparing the estimates of national income both at current and constant prices.

The incomes of different regions can be compared to study the regional disparities in incomes. Some of the regions may be more developed while some others may be less developed e.g. Punjab is more developed than Assam. The per capita income, along with certain other indicators, gives us an idea of regional disparity. These estimates of different states are a guide in deciding the allocation of central funds to various states.

8.2.3 Sectoral Distribution of Income

The estimates of national income show contributions of different sectors of the economy, such as agriculture, manufacturing, transport, electricity services etc. From the sectoral break downs of national income, one could study the broad sectoral shifts in an economy over time. For example, based on the sectoral estimates it can be said that agriculture is overwhelmingly important for the Indian economy. In fact in the past Indian economy used to be called an agricultural economy. The contribution of gross value added from agriculture decreased from 35.8% in 1980-81 to 22.2% in 2000-2001 (at 1993-94 prices). The contribution from manufacturing industries increased from 13.8% to 17.2% during the same period. The contribution from other sectors also showed an increase over this period. This shows that over period of time there is a shift from agriculture (in 1950-51, the contribution from agriculture was 50.2%) to manufacturing and other sectors. That means more emphasis is being given to infrastructure and industries.

8.2.4 Income Distribution by Factors of Production

National income estimates throw light on the distribution among different categories of income such as wages, profits, rent and interest. The distribution of income into wage and non-wage income is of special importance, since the inequality in the personal distribution of income depends to a great extent on the share of working class (wages) and the share of property owners. From the **size distribution** of income one can have an idea about the number of people who are poor.

8.2.5 International Comparison of National Income

National accounts are used for reporting to international agencies like U.N. Statistical Office. **U. N. Year Book** on **National Accounts** gives national and per capita incomes of more than 120 countries. The national accounts statistics should confirm to standard, internationally accepted concepts, definition and classifications. The resulting data are widely used for international comparisons of the volumes of major aggregates such as GDP or GDP per head, and also for comparisons of structural statistics, such as ratios of investment, taxes, or government expenditures to GDP. Such comparisons are used by economists, journalists and other analysts to evaluate the performance of one economy against that of other similar economies. They can influence popular and political judgements about the relative success of economic programmes in the same way as developments over time within a single economy. Data bases consisting of a set of national accounts for groups of countries can also be used for econometric analysis.

Levels of GDP, alternatively, gross national income (GNI) per head in different countries, are used by international ogranisations to determine eligibility for loans, and or other funds or conditions on which such loans, and or funds are made available and also to determine the share of their contributions to expenditures of various international bodies.

There are certain inherent problems in the international comparison of the estimates of national incomes of different countries, because of different currencies and different set of prices prevailing in these countries. For comparing the values of goods and services produced or consumed per head,

data in national currencies must be converted into a common currency by means of purchasing power parities and not exchange rates. It is well known that, in general, neither market nor fixed exchange rates reflect the relative internal purchasing powers of different currencies. Exchange rate converted data cannot, therefore, be interpreted for measuring the standard of living of different countries.

Check Your Progress 1

1) Briefly describe how national income accounts can be used to measure standard of living.

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2) What measures have to be ensured for a meaningful comparison of national income estimates across time and span?

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8.3 PLANNING AND POLICY PURPOSES

National income estimates also contain the estimates of consumption, saving and capital formation. Information regarding consumption, saving and investment is indispensable for studying the economic growth and for planning. The rate of saving and investment in an economy determines the rate of growth of the economy.

The whole concept of long-term development depends on current level of income and investment obtained from national income statistics. The projections and target setting depends upon the sectoral breakdown of national income.

At a more sophisticated level, extensive use of data on consumption expenditure can be made to study the disparities in the level of living and also the changes over period of time. The estimates of people under poverty line can be obtained from the consumption data.

Economic policy in the short run is formulated on the basis of an assessment of the recent behaviour and the current state of the economy and a view of a better forecast, about likely future developments. Short-term forecasts are made by using econometric models. Over the medium or long term, economic policy has to be formulated in the context of a broad economic strategy which may need to be quantified in terms of a plan. Most of the elements which make up a medium or long term economic plan consist of national account flows, and it may be impossible to draw up such a plan without them. A good macro economic model which accurately reflects the past performance of the economy may be indispensable for planning and forecasting.

For target setting at sector levels the forecasts for the macro aggregates are transformed into sectoral levels by making use of certain other models like consumption model and certain other assumptions like reduction in poverty. Having sector level forecasts of the macro variables the targets of production can be set by making use of an input-output or any other similar disaggregated model.

Economic policy-making and decision-taking take place at all level of government and also within public and private corporations. Large corporations have their own macro economic models tailored to their own requirements, for which they need national accounts data. The investment programmes of these corporations must be based on long-term expectations about future economic developments that require national accounts data.

For budget making and deciding about the taxation policy the government required detailed data regarding production levels of different industries, their demands, etc. By looking at the detailed sector wise estimates, the government can decide about the stimulus to be given to different sectors for growth.

No development plan is possible without national income estimates. These estimates are essential for fixing targets of production and employment. The achievements of the targets laid down in the plans can be known from the changes in national income and its various components.

8.3.1 Data Base of the Economy

National income estimates lay the strong foundations of the data base of the economy. For having reliable estimates of national income, we must have a reliable data base. Over period of time studies and surveys are conducted to improve the data base of the economy.

8.3.2 Monitoring the Movements of Different Economic Flows

National accounts data provide information covering both different types of economic activities and the different sectors of the economy. It is possible to monitor the movements of different economic flows such as production, household consumption, capital formation, wages, profits, etc. (the flows of gods and services being carried out at constant and current prices). Moreover information is provided about certain key balancing items and ratios which can be defined and measured within an accounting frame-work. One such example is the trade balance, and the other is the share of income which is saved or invested by different sectors of the economy or the economy as a whole. National accounts also provide the back ground against which movements of short term indicators, such as monthly indices of industrial production, or of consumer or producer prices, can be interpreted and evaluated.

8.3.3 Causal Relationship between Macro Variables

National accounts are also used for investigating the causal relationship at work within an economy. Such analysis usually takes the form of the estimation of the parameters of functional relationship between different economic variables by applying econometric methods to time series data complied within a national accounting framework. (The relationship between consumption, investment and income) The types of macroeconomic models used for such investigations may vary according to objective of the analysis as well as the stage of development of the economy. Advances in computers have made it possible for the econometric analysis of large macroeconomic models. Many econometric software packages have been developed and the models could be used even by institutions having only limited resources available for this purpose.

UNIT 11 POVERTY, INEQUALITY AND INCLUSIVE GROWTH: SOME POLICY IMPLICATIONS

Structure

11.0 OBJECTIVES

After reading this unit, you will be able to:

- define the concept of poverty;
- state different income and non-income indicators of poverty;
- identify the income and non-income dimensions of poverty in India;
- explain the concept of inequality;
- identify the income and non-income measures of inequality;
- analyse the level of inequality in India;
- state the concept of inclusive growth;
- examine the status of India in terms of inclusive growth; and
- explain the policy implications on poverty, inequality and inclusive growth.

11.1 INTRODUCTION

To begin the discussion, on poverty, inequality and inclusive growth, two important points need be stated: (i) Poverty, inequality (and hence need for inclusive growth) and unemployment are inter-related issues. One cannot be appreciated without knowing the dimensions of the other; and (i) we need to distinguish between the concept of absolute poverty and the concept of relative poverty. As to the first, it need be made clear that a simple increase in the GDP may not be a sufficient condition (although a necessary condition) to enable all sections of the society – asset owners and asset – less to share in the fruits of growth. On the contrary, empirical evidence has clearly demonstrated that the benefits of growth are unevenly distributed (especially when an economy is in transition from a low-income category to a high-income category). With a time lag as the growth process continues, the distribution of income begins to become more even. This relationship between growth and distribution of income has given rise to kuznets' famous hypothesis reflected in kuznets' inverted U-shaped curve.

Secondly, absolute poverty explains a situation in which some persons, small or large in number, live in a state of destitution. In this pitiable situation, these persons (or groups of persons) fail to meet their basic needs. They may live at bare subsistence, or even below subsistence. This however does not have any implication for the size of cake available for distribution. Here, again, two situations can be visualised. One, the size of the national cake may be so small, that it is not adequate to meet the minimum needs of all sections of the society. Two, the size may be fairly large, but the existing institutions and practices do not result in equitable distribution, so that a large part of national product goes to enrich the pockets of a few, and the large mass are left to take care of themselves. Whatever the situation may be, if a meaningful effort is to be made to lift poor persons to a respectable level of living, inclusive growth will be the answer.

11.2 THE CONCEPT OF POVERTY

In the development literature, poverty is defined as 'multi-dimensional' which is measured not just with respect to lack of income, but also directly with respect to basic needs such as health, education, nutrition and shelter. In the broader approach, poverty includes the lack of social security and empowerment. All the income and non-income aspects of poverty help us to understand whether an individual is living decently and respectfully or not. The broader definition is promoted by UNDP in 'Human Development Report' and World Bank in 'World Development Report'. It defines poverty as 'a human condition characterised by the sustained or chronic deprivation of the resources, capabilities, choices, security and power necessary for the enjoyment of an adequate standard of living and other civil, cultural, economic, political and social rights.' (UN, 2001).

The broader approach of poverty (well being) is defined by the Noble Laureate Prof Amartya Sen as well being that comes from capability to function in the society. Poverty arises in the society where its subjects lack capability, for example, inadequate income or health, low self confidence or powerlessness. Hence Sen's definition of poverty arises from lack of capability, not merely from low income. Sometimes the poverty is defined in terms of 'human rights approach' that define poverty as the violation of economic, political, social and civil rights. The rights may be right to education, right to minimum health, right to decent living and right to employment. These rights ensure an individual to be above the minimum threshold of capability.

11.3 MEASUREMENT OF POVERTY

Before analysing the measurement of poverty, it is necessary to have a clear cut idea that why do we need to measure poverty or in other words what is the benefit of measuring poverty. Poverty measurement is a powerful instrument to focus the attention of policy maker or government to focus on the living condition of poor. The second reason for measuring poverty is targeting. The measure of poverty clearly analyses the extent and gravity of poverty that varies among different geography (rural, urban, hilly, tribal dominated), different social categories of population (Scheduled caste, Scheduled tribe, Muslims, women headed households, households without earning members) etc. Take some example to explain this point. If the poverty among agricultural labour is high, government can take some measure so that this section of population can bridge the poverty gap by providing cheap credit facility, housing facility, different type of training facility etc. Likewise, if among ST population, the poverty rate is high than government can take some specific measure for this section of population. Poverty measurement also helps many international agencies to easily target the extremely poor region for intervention (within their limited resources). The measurement of poverty also helps the government to evaluate the policies and programmes specifically implemented to eradicate poverty. For example, if the KBK (Kalahandi-Koraput-Bolangir) region in Odisha is most poverty ridden, then government can implement some focused programmes in the same region. If we found that despite the implementation of different programmes, the poverty level in the region is high, the government can again review the policy and prgrammes. Ravallion (1998) points out that, "a credible measure of poverty can be a powerful instrument for focusing the attention of policy makers on the living conditions of the poor."

11.3.1 Income Indicators of Poverty

At the outset, in estimating the incidence of poverty, we need an income threshold or poverty line to identify the poor. Income cut-offs used to identify the poor are often viewed as arbitrary. The poverty line can be defined as the minimum requirement of an individual for a healthy living. The minimum requirement can include both food and non-food items. There are many income poverty measures. We have discussed below some of the important poverty measures frequently used by researchers.

a) **Head Count Index (HCR)**

The most widely used poverty measure is the *headcount index*, which simply measures the proportion of the population that is counted as poor. In other words the incidence of poverty is defined as the proportion of poor to the total population.

$$\text{Poverty HCR} = \frac{\text{No. of People below poverty line (Np)}}{\text{Total population (N)}} \times 100$$

For example, if 120 people out of 600 total population are poor, then the proportion of population below poverty line is calculated as 20 per cent (120/600 × 100=20 per cent). This is expressed in per centage. The headcount index is is simple to construct and easy to understand and helps to compare among different subgroup/ areas (like rural/urban or social category such as SC/ST/OBC or different states) in a point of time or over a period of time. HCR enables us to know whether poverty rate is reducing and if reducing what is the pace of reduction.

However, the HCR method is not free from limitations. Firstly, the head-count index does not indicate how poor the poor are, and hence does not change if people below the poverty line become poorer. Moreover, the easiest way to reduce the headcount index is to target benefits to people just below the poverty line, because they are the ones who are cheapest to move across the line. But by most normative standards, people just below the poverty line are the least deserving of the poor. This can be explained by way of an example. Let us take two countries i.e. country 'A' and country 'B' and each having four persons.

HCR of Country A and B assuming poverty line 450

HCR of Country A and B assuming poverty line 450					
	Expenditure 1st individual	**Expenditure 2nd individual**	**Expenditure 3rd individual**	**Expenditure 4th individual**	**HCP**
Country A	250	275	500	500	50 per cent
Country B	448	449	500	500	50 per cent

If the poverty line is 450, then in both the countries 50 per cent of people are below poverty line, but country A shows the high intensity of poverty as compared to country B. Hence the proportion of people just below poverty line are less deserved poor as compared to the people lying far from poverty line. Secondly the HCR calculate poverty level by household. Hence if for a community or area where the family size is high, the per centage of poor is higher as compared to low family size area. Again the intra household issue of poverty is not captured by this method and we assume that the level of well being is same for all the household members. But in many cases, it is found that poverty level among girl child or senior people are higher than the adult member within the same household. The depth and severity of poverty can not be captured by the HCR method. This is captured by poverty gap index.

b) **Poverty Gap Index (PGI) and Squared Poverty Index (SPI)**

PGI is another measure that is derived from income or expenditure distribution. This measure shows how far below is the income/consumption from poverty line. In other words, it indicates the shortfall of poor relative to poverty line.

The PGI, which adds up the extent to which individuals on average fall below the poverty line, and expresses it as a per centage of the poverty line. More specifically, the poverty gap (*Gi*) is the poverty line (*z*) less actual income (*yi*) for poor individuals; the gap is considered to be zero for everyone else.

$$\text{PGI}= \frac{1}{N}\sum_{i=1}^{n}\left(Z-Y_i\right)|Z \quad \left(Y_{-1}<Z\right) \qquad ...(1)$$

On the other hand the Squared Poverty Index (SPI) is simply a weighted sum of poverty gaps (as a proportion of the poverty line), where the weights are the proportionate poverty gaps themselves; a poverty gap of (say) 20 per cent of the poverty line is given a weight of 20 per cent while one of 50 per cent is given a weight of 50 per cent; this is in contrast with the poverty gap index, where they are weighted equally.
The SPI can be defined in equation as

$$\text{SPI}= \frac{1}{N}\sum_{i=1}^{n}\left(\left(Z-Y_i\right)|Z\right)^2 \quad \left(Y_i<Z\right) \qquad ...(2)$$

(N = total population, Z = Poverty line, Yi = Income/consumption expenditure)

The PGI and SPI can be explained with the help of a numerical example given below.

Calculating the Poverty Gap Index (PGI) and Squared Poverty Index (SPI), assuming poverty line of 130				
	Expenditure of each individual			
Expenditure in country A	110	115	150	160
Poverty gap	(130–110)=20	(130–115)=15	0	0
Gi/z	20/130=0.15	15/130=0.12	0	0
$(Gi/z)^2$	$(0.15)^2$=0.024	$(0.12)^2$=0.013	0	0
Poverty Gap Index = (0.15+0.12)/4 = 0.07				
Square Poverty Index = (0.024+0.013)/4 =0.009				

You can check the above example where expenditure of first and second individual is 110 and 115 respectively (poverty gap is low) and for other two person this is the same, the PGI = 0.07 and SPI=0.009 whereas if the expenditure of first and second individual is 75 and 80 respectively then the PGI and SPI will be 0.20 and 0.082 respectively.

c) **Sen Index (P_S)**

Prof. Sen developed this index which combine the effect of number of poor, the depth of their poverty, and the distribution of poverty within the group. This can be defined in the equation as

$$P_s = P_0\left(1-\left(1-G^P\right)\frac{\mu^P}{z}\right)$$

where P_0 is the headcount index, μ^P is the mean income (or expenditure) of the poor, and G^P is the Gini coefficient of inequality among the poor. There are two other measures the 'Sen-Shorrocks-Thon index' and the 'Watts Index' which we shall not go into detail.

11.3.2 Income and Non-Income Indicators of Poverty

As discussed in above sub section, the poor are identified by setting a poverty line on the basis of household consumption expenditure or income. The well being of a person defined on the basis of income or consumption expenditure is a unidimensional approach and this does not provide the complete picture of the extent of deprivation. Hence there is a need to define a multidimensional picture of poverty which includes several non income indicators like housing status, sanitation status, health status (child mortality, maternal mortality rate, morbidity), educational status etc.

Since 1990, UNDP has been preparing the Human Development Index by using three most important attainments such as

i) **Longevity:** The choice to lead a healthy life

ii) **Educational attainment:** The choice to acquire knowledge

iii) **Economic attainment:** To have access to the resources needed for a decent level of living

The countries ranked are on the basis of the composite indicators of the three choices. The HDR also estimates the Human Poverty Indices by taking three deprivations such as

i) Proportion of population not expected to survive beyond 40 years

ii) Adult literacy rate

iii) Per centage of population without sustainable access to an improved water source and per centage of children aged 5 or below who are underweight for their ages.

Under the UNDP framework, the Planning Commission has also prepared the India's human development report by including 15 major states. The selection of indicator in planning commission's HDI is to some extent different from that of UNDP report. The basic difference between these two reports are given below. UNDP HDI takes life expencency at birth, whereas the planning commission takes life expectancy at age 1 and IMR for longevity.

- For educational attainment, UNDP has taken adult literacy and enrolment ratio whereas planning commission has taken literacy 7+ and intensity of formal education.
- For economic attainment, UNDP has taken real GDP but planning commission has taken real per capita consumption expenditure adjusted for inequality.

By taking the above parameter, a composite index of diverse indicators is obtained and the countries or states are ranked according to the composite value of index.

Gender Related Development Index (GDI) or Gender Equality Index (GEI)

The human development index devised by planning commission or UNDP explain the over all development or well being of a person. But this attainment does not reflect gender based disparity in such attainment. In many of the indicators, the gender based disparity is there which directly or indirectly affects the poverty level of female population as compared to its male counterpart. The GEI has been estimated to measure the inequality in attainments on human development indicators between females and males. This approach helps the policy makers to reflect more on the gender related programmes and policies. The same three indicators are used for males and females separately and the gap of males and females in these attainmens are found. The index has been presented as a ratio of attainments for females to that of males.

Capability Poverty Measure (CPM)

UNDP has also developed a new multi dimensional measure of human deprivation called the capability poverty measure (CPM). The CPM focuses on human capabilities. The capability poverty measure reflects per centage of people who lacks basic essential human capability.

The CPM considers the lack of three basic capabilities:

- The first is the lack of being well nourished and healthy represented in this case by the proportion of children under five years who are underweight.
- The second is the lack of capability for healthy reproduction, shown by the proportion of births unattended by trained personnel.

- The third is the lack of capability to be educated and knowledgeable, represented by female illiteracy.

11.4 DIMENSIONS OF POVERTY IN INDIA: THE INCOME AND NON-INCOME DIMENSION

The first step to estimate poverty rate is to define and quantify poverty line.

The Task Force on 'Projection of Minimum Needs and Effective Consumption Demand' constituted by the Planning Commission in 1979 defined the poverty line as per capita consumption expenditure level based on the nutritional requirement of 2400 calories per capita per day in rural areas and 2100 calories per capita per day in urban areas along with a minimum of nonfood expenditure. It used the age-sex-activity specific calorie allowances recommended by the Nutrition Expert Group (1968) to estimate the average daily per capita requirement for rural and urban areas using the age-sex-occupational structure of their respective population. They found out the monetary convert for the said kcal for both rural and urban areas. The poverty line is hence partly normative and partly behavioural as it takes the value of minimum calories requirement by a person along with a minimum non-food requirement like clothing, shelter, transport etc. By taking 28th round NSS data, the Task Force estimated that on an average, consumer expenditure of Rs. 49.09 per capita per month meet the requirement of 2400 calories in rural area and Rs. 56.64 per capita per month with an intake of 2100 calories per capita per day in urban areas. The same poverty line defined at national level (separately for rural and urban areas) was used in all the States/Union Territories (UTs). The expert group constituted by the Planning Commission in September 1989 on Estimation of Proportion and Number of Poor realised that due to inter state variation in prices the same all India poverty line cannot be used for all the states and union territories. Hence the expert group disaggregated these national level poverty lines of the Task Force into state-specific poverty lines using state-specific price indices and inter state price differential. The expert group took the state-specific cost of living indices for estimating and updating the poverty line separately for rural and urban areas. The poverty line inflated from time to time depending on the cost of living index. The poverty line as calculated in various rounds of NSS survey is given in Table 11.1.

Table 11.1: Poverty Line (Rs. Monthly Per Capita).

Year	Rural	Urban
1973-1974	49.63	56.76
1977-1978	56.84	70.33
1983	89.50	115.65
1987-1988	115.20	162.16
1993-1994	205.84	281.35
1999-2000	327.56	454.11
2004-2005	356.30	538.60

Source: Planning Commission (1997), Press Information Bureau (2001), Press Information Bureau, (2007).

The Planning Commission set up an expert group under the chairmanship of Prof. Suresh Tendulkar to examine the issue relating to new poverty line and estimates. The expert group submitted their report in the year 2009. The committee has

taken the NSSO quinquennial household consumption expenditure survey. The committee has taken the Mixed Reference Period (MRP) based estimate. The committee has taken the consumption poverty line as the reference poverty line basket of household goods and services consumed by those households at the borderline separating the poor from non-poor. The expert committee's proposed price indices are based on the household level unit value obtained from 61st round NSS household consumption expenditure survey for different food and non-food items for both rural and urban areas. As Tendulkar Committee adopted new reference basket and new price indices, hence it is not comparable with the official head count ratio. Table 11.2 explains the poverty line and per centage of population below poverty line. The per centage of rural population below poverty line declined to 33.8 per cent in 2009-10 from 41.8 per cent in 2004-05 in rural India.

Table 11.2: Poverty Line (Rs. Monthly Per Capita).

	Poverty Line (Rs)		Poverty Head Count Ratio (per cent)	
Year	**Rural**	**Urban**	**Rural**	**Urban**
2004-05	446.68	578.80	41.8	25.7
2009-10	672.80	859.60	33.8	20.9

a) **Income Poverty Indicators**

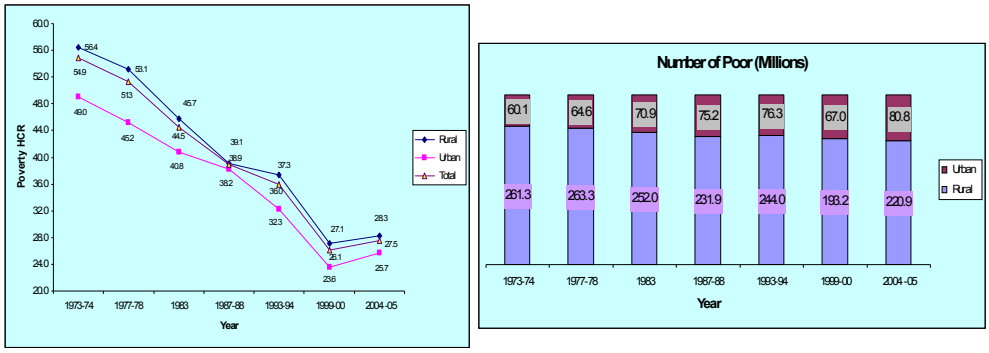
- Over the time period, India has shown a dramatic reduction in poverty which is well documented by the researchers. During the period between 1973-74 and 2004-05, the incidence of poverty declined continuously from 54.9 per cent to 27.5 per cent or the absolute number of poor decreased from 321.3 million in 1973-74 to 301.7 millions in 2004-05. In rural areas the poverty level reduced from 56.4 per cent to 28.3 per cent and in urban areas the same has reduced from 49 per cent to 25.7 per cent.
- However one thing should be kept in mind that the pace of reduction in poverty varies considerably during this period with a large decline in 1983 and a very small decline in 1993-94. The number of people below the poverty line increased by 7.6 million during the 1973-74 to 1977-78 and decreased by 21.8 million during the 1983 to 1987-88 and by 6.4 million during 1987-88 to 2004-05 (see Table 11.3).

Table 11.3: HCR Poverty in India, 1973-74/2004/05.

Year	Head Count Ratios (per cent)			Absolute No.of Poor Below Poverty Line(in million)		
	Rural	**Urban**	**Total**	**Rural**	**Urban**	**Total**
1973-74	56.4	49	54.9	261.3	60.1	321.3
1977-78	53.1	45.2	51.3	263.3	64.6	328.9
1983	45.7	40.8	44.5	252	70.9	322.9
1987-88	39.1	38.2	38.9	231.9	75.2	307.1
1993-94	37.3	32.3	36	244	76.3	320.4
1999-00	27.1	23.6	26.1	193.2	67	260.2
2004 -05	28.3	25.7	27.5	220.9	80.8	301.7

Source: Planning Commission downloaded from 'http://planningcommission.nic.in/news/conference/part2.pdf'

Graph 1: Trend of Poverty- Head Count Ratio and Number of poor.



Source: Planning Commission downloaded from

'http://planningcommission.nic.in/news/conference/part2.pdf'

The trend of poor is clearly visible in the above graph. The diagram shows that the rural share of total poverty is 81 per cent during 1973-74 which reduced to 73 per cent (8 per centage point reduced) in 2004-05. The number of urban poor increased by 10.6 million during 1973-74 to 1987-88.

- Highest levels of HCR among SCs and STs go with the highest depth as well severity of poverty.

The head count poverty by social category from the year 1983 to 2004-05 has been provided in tables. The poverty rate among STs reduced by 19.5 per centage point (from 63.9 per cent in 1983, 44.7 in 2004-05), whereas for SCs the per centage point reduction is 20.5 (from 58.4 in 1983 to 37.9 per cent in 2004-05). The per centage point reduction for other caste population is 18.4 per cent. The poverty rate in rural areas is high as compared to urban areas.

Table 11.4: Poverty rates among social category (1993-94 and 2004-05).

Location	Social Category	1983	1993-94	2004-05	Change 1983 to 2004-05
Rural	ST	63.9	50.2	44.7	19.2
	SC	59.0	48.2	37.1	21.9
	Other	40.8	31.2	22.7	18.1
	All	46.5	36.8	28.1	18.4
Urban	ST	55.3	43.0	34.3	21.0
	SC	55.8	50.9	40.9	14.9
	Other	39.9	29.4	22.7	17.2
	All	42.3	32.8	25.8	16.5
Total	ST	63.3	49.6	43.8	19.5
	SC	58.4	48.7	37.9	20.5
	Other	40.5	30.7	22.7	17.8
	All	45.6	35.8	27.5	18.1

Source: 'Poverty and Social Exclusion in India' The World Bank, 2011, Page 11.

- Poverty rates by religion in the year 2004-05 shows that poverty rate is highest among Buddhists (40.59 per cent) followed by Zorastrians (36.02 per cent). The rate is lowest among Sikhs (5.0 per cent) followed by Jains (2.59 per cent).

It may be noted that poverty is getting concentrated in few states and social groups. A group of four states comprising Bihar, M.P., Orissa and U.P. had a share of 49.8 per cent in the rural poor of the country in 1983. This share increased to 55 per cent in 1993-94 and further to 61 per cent in 2004-05.

- The poverty gap ratios have been incorporated in table 11.5 separately for rural and urban areas. About 16.56 per cent of the total consumption in the rural areas in 1973-1974 was needed to bring the poor to the poverty line whereas this came down to 5.70 per cent in 2004-05. The trend was the same in the urban areas where 13.64 per cent of the total consumption was needed to bring the poor to the poverty line in 1973-74 and only 6.12 per cent in 2004-05.

Table 11.5: Poverty gap ratio (Percentage).

Year	Rural	Urban
1973-1974	16.56	13.64
1977-1978	15.73	13.13
1983	12.32	10.61
1987-1988	9.11	9.94
1993-1994	8.45	7.88
1999-2000	5.11	4.84
2004-2005	5.70	6.12

Source: Estimated from the household consumer expenditure data of the NSSO, various Rounds.

b) Income and non-income indicators of Poverty

So far we have discussed poverty expressed by way of poverty ratio. No doubt it is an important aspect of the living standard, but this does not reflect certain aspects of non-income poverty expressed by way of the measures like health, education, nutrition, human development index, human poverty index, gender inequality index etc. Let us discuss the Indian situation in terms of non-income measure of poverty.

The National Human Development Report for India was prepared by Planning Commission in the year 2001. In the HDI index it has taken only the major states and in calculating the HPI it has taken all states. The HDI for the backward states like Bihar (0.367), Uttar Pradesh (0.388), Madhya Pradesh (0.394), Orissa (0.404) shows a very dismal performance as compared to the developed states like Kerala (0.638), Punjab (0.537), Tamil Nadu (0.531). In terms of Human Poverty Index the states like Rajasthan (46.67), Madhya Pradesh (43.47), Uttar Pradesh (48.27), Bihar (52.34), Orissa (49.85) have a relatively higher incidence of poverty. On the other hand the states like Kerala (19.93), TN (29.28), Punjab (25.06), Maharashtra (29.25) and Gujarat (29.46) shows a good performance.

Status of India on Capability Poverty Measures

On capability poverty measures also India fares poorly. The Body Mass Index (calculated below18.5kg/m^2) of women shows that 35.6 per cent of women are below 18.5 kg/m^2. The per centage is almost same as that was in 1998-99. Bihar occupied the highest and Sikkim occupied the lowest position in 2005-06. The weight for age (underweight), height for age (stunting) and weight for height (wasting) are the three important anthropometrical measures that shows the nutritional status

of child. The per centage of underweight children was as high as 42.5 per cent in 2005-06. It reduced only by 11 per centage point from 1992-93. Madhya Pradesh bears the highest per centage of underweight children in India. Uttar Pradesh has the highest per centage of stunted children (48.0 per cent) in India.

Check Your Progress 1

1) In what way is the PG index more useful in assessing the poverty situation?

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2) Name the indicators which take note of income as well as non-income aspects of poverty.

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3) Do you find any difference in the trend of poverty reduction by social category and religion? Give reasons in support of your answer?

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4) What are the indicators of capability poverty measure?

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11.5 THE CONCEPT OF INEQUALITY

Literally, inequality means the lack of evenness or social disparity or disparity of distribution or opportunity, services, benefits or being unequal. In other words inequality is related to unequal access or different degrees of access of different individuals or groups of individuals to these opportunities, services and benefits. It looks at the relative levels of access of different groups to development opportunities and benefits. As inequality increases disparity also increases. The inequality occurs due to physical attributes (distribution of natural ability is not equal), personal preference (distribution between leisure and work), social process (pressure to work or not to work varies) and public policies (policy affects distribution of resources).

The analysis of inequality helps the policy maker to target a particular group of people or to a particular area.

11.6 INEQUALITY MEASUREMENT: THE INCOME AND NON-INCOME MEASURE

11.6.1 The Income Measure

There are different methods to measure inequality. The most commonly used measures of inequality are as follows:

Range: The range is simply the difference between the highest and lowest observation. If we have four observation i.e. 115, 78, 45, 220, the range will be equal to (220–45)=175. This method is very simple and easy to calculate and at the first hand gives us an impression on inequality. But the serious drawback of this method is that it ignores all other observations excluding two. The result is heavily affected by skewed out liers.

Range Ratio: Range ratio is calculated by dividing the income/expenditure of predetermined highest and lowest per centile. For example, if the income of 15 persons are 45, 48, 78, 87, 98, 120, 200, 221, 238, 250, 252, 267, 287, 322, 327 respectively and if we choose the 95th and 5th per centile than the range ratio will be

95th Per centile {(95/100×15)=14th person's income}322/ 5th per centile {(5/100×15)= 1st Person's income}45=7.16

This method is easy to understand and calculate and also minimise to some extent the heavy out layer. Like range method, the range ratio also has taken into account only two observations and this does not weigh other observations.

The McLoone Index: The McLoon Index divides the summation of all observations below the median, by the median multiplied by number of observation below median. In the above example median value is 221. Hence the sum of below median value is =45+48+78+87+98+120+200=676

Hence McLoone Index=676/(221×7)=0.44

This method is easy to understand and comprehensive information on bottom half. The limitation of this index is that the above median observation is not taken into account.

Coefficient of Variation

The coefficient of variation (CV) is a distribution's standard deviation divided by its mean. For a clear understanding let's take an example of income of five persons in three countries.

Table 11.6

Person	Country 1	Country 2	Country 3
1	50	48	18
2	50	50	78
3	50	51	12
4	50	49	48
5	50	52	94
Mean	50	50	50
SD	0.0	1.4	32.2
CV	0.00	0.03	0.64

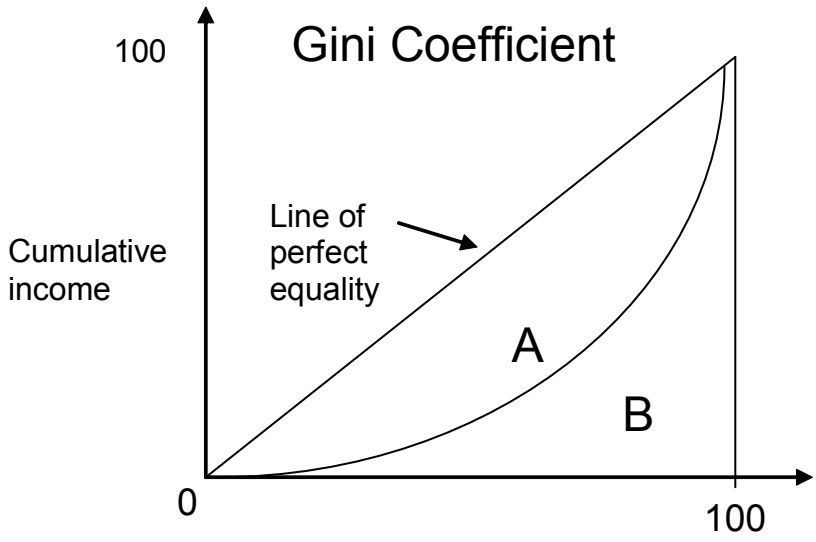
The above table shows that the income distribution in country 1 has perfect equality as the dispersion of income is zero, whereas in country 2 the dispersion is 1.4 (low) and in country 3 the dispersion is extremely skewed. The CV is weighted and fairly easy to understand.

Lorenz Curve

Lorenz Curve is a graphical representation of the proportionality of a distribution. It represents a probability distribution of statistical values, and is often associated with income distribution calculations and commonly used in the analysis of inequality. The population in the Lorenz curve is represented as households and plotted on the **x** axis from 0 per cent to 100 per cent. The income is plotted on the **y** axis and is also from 0 per cent to 100 per cent.

This can be plotted by a graph. In the graph shown below OX axis represents per centage of population and OY axis represents per centage of income.

If income distribution were perfectly equal then the cumulative per centage population will be exactly equal to cumulative per centage of income. The perfect equality line forms an angle of 45 degrees with a slope of 100/N.The Gini coefficient is derived from the Lorenz curve.



The Gini coefficient is defined graphically as a ratio of two surfaces involving the summation of all vertical deviations between the Lorenz curve and the perfect equality line (A) divided by the difference between the perfect equality and perfect inequality lines (A+B).If the area between the line of perfect equality and Lorenz

curve is A, and the area under the Lorenz curve is B, then the Gini coefficient is A/(A + B).

The major limitation of the method is that when comparing two Lorenz curves, it is not possible to determine which distribution has more inequality if the two curves intersect. It does not take into account the life time income. The construction of a Lorenz curve does not consider the ages of the persons, who receives income. The income of a young individual who enters jobs recently, those in mid-career and those of the old people who have retired, are not the same. But the Lorenz curve does not distinguish incomes by ages and reflects inequalities across all ages. It is therefore not correct to group the incomes of the people belonging to different age groups for measuring income inequality.

11.6.2 The Non-Income Measures

As analysed in the above section, the quality of life is measured in terms of both income and non-income aspect. The non-income aspect includes the access to safe drinking water, access to sanitation, access to education and health, employment opportunity. The levels of access of different facilities are measured in terms of inequality indicators. The level of access of different services varies among social groups, gender, geographical areas etc.

11.7 LEVEL OF INEQUALITY: THE INCOME/ CONSUMPTION AND OTHER NON-INCOME MEASURES

Over the recent years, the growth rate of GDP marked a spectacular progress. It increased from 3.5 per cent in 1950-51/1979-80 to 5.5 per cent in 1980-81/ 2000-01 and 7 per cent in 2001-02/2009-10. At the same time, the poverty rate has also declined to a significant extent. However, with the increased growth and reducing poverty, increased inequality in income and non-income aspects is observed. This means that a small segment of population has benefited from the fruits of economic growth and it has not percolated down to a large segment of population with the symptoms like low wages, little or no social services, and very little opportunity for improved mobility. The data available in Table 11.7 shows that the average monthly per capita consumption expenditure (MPCE) for poor was Rs 35.10 in 1973-74 and that of non-poor was Rs. 76.30. The poor have about 57 per cent less MPCE as compared to non-poor. On the other hand in 2004-05, the MPCE of poor and non-poor is Rs 284.80 and 666.90 respectively. This shows that the poors consumed about 42.7 per cent less as compared to non-poor. The Gini Coefficient of consumption expenditure was 0.2758 and 0.3013 in 1973-74 in rural and urban areas respectively. The Gini coefficient in 2004-05 and the inequality in distribution of consumption was 0.25 and 0.35 respectively..

Rural monthly per capita expenditure (MPCE) as per cent of urban MPCE declined from 75 per cent in 1973-74 to 61.4 per cent in 1993-94 and to 56 per cent in 2004-05 at all India level (Table 11.7). Again the above table shows that the gap in MPCE between poor and non-poor in both rural and urban is extremely high. The rural monthly per capita consumption expenditure of poor as a per centage of non-poor increased from 46 per cent in 1973-74 to 46.8 per cent in 1999-00 to 42.7 per cent in 2004-05. On the other hand the MPCE of poor as a per centage of non-poor in urban areas declined for 42.3 per cent in 1973-74 to 35.8 per cent in 1999-00 and further to 32.3 per cent in 2004-05.

Table 11.7: Average monthly per capita expenditure (Rs. per month at current price) and Gini Coefficient of Distribution of Consumption, 1973-2005.

Year	Rural			Poor MPCE as per cent of non-poor	Urban			Poor MPCE as per cent of non-poor	Rural MPCE as per cent of urban	Gini Coefficient of Distribution of Consumption	
	Poor	Non-poor	Total		Poor	Non-poor	Total			Rural	Urban
1973-74	35.10	76.30	53.0	46.0	41.00	97.00	70.80	42.3	74.9	0.2758	0.3013
1993-94	159.20	353.60	281.4	45.0	212.80	575.40	458.00	37.0	61.4	0.2819	0.3400
2004-05	284.80	666.90	558.8	42.7	410.80	1273.30	1052.30	32.3	56.0	0.25	0.35

Source: (1)Reports of household consumer expenditure surveys conducted by NSSO.

(2) Gini Coefficient: From 1973-74 to 1999-00 taken from ERD Working Paper No. 51

Poverty Estimates in India: Some Key Issues, Assian Development Bank, 2004 and for 2004-05 taken from planning commission http://planningcommission.nic.in/data/datatable/1705/final_42.pdf

Inequality in distribution of consumption expenditure

The Table 11.8 shows the decile share of consumption expenditure. In rural areas the first decile (most poor) occupied with only 4 per cent of total consumption expenditure in rural areas in 1973-74 which increased to 4.13 per cent in 1993-94 and 4.08 per cent in 2004-05. On the other hand the highest quintile of people (most rich) occupied with about 22.88 per cent of rural consumption expenditure which has increased to 24.34 per cent in 1993-94 and 26.41.in 2004-05. Similar trend continued in urban areas.

Table 11.8: Deciles share of consumption expenditure in India.

Deciles	1973-1974		1993		2004-05	
	Rural	Urban	Rural	Urban	Rural	Urban
1st	4.02	3.90	4.13	3.37	4.08	3.07
2nd	5.52	5.27	5.51	4.65	5.32	4.19
3rd	6.46	5.90	6.31	5.54	6.12	5.07
4th	7.23	7.03	7.16	6.33	6.91	5.94
5th	8.17	7.68	7.98	7.31	7.72	6.95
6th	9.15	9.21	8.89	8.37	8.64	8.15
7th	10.38	9.33	10.06	9.77	9.74	9.64
8th	11.98	12.35	11.56	11.82	11.26	11.66
9th	14.21	14.21	14.06	15.18	13.81	15.13
10th	22.88	25.21	24.34	27.66	26.41	30.21

Source: Reports of household consumer expenditure surveys conducted by NSSO.

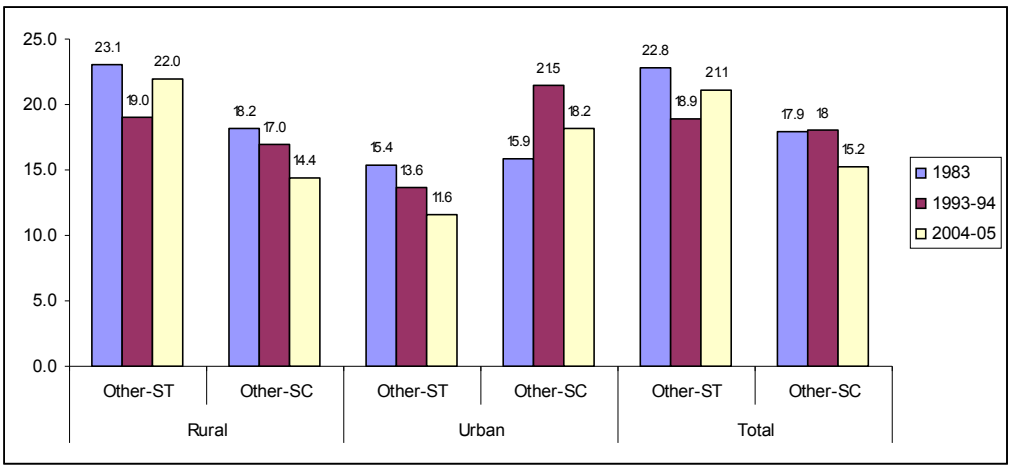
A big inequality is also observed among states in terms of monthly per capita consumption expenditure. Among the major states Delhi occupies the highest place.

The MPCE in rural Bihar rised from Rs. 93.76 in 1983 to Rs. 417.11 in 2004-05. On the other hand, in rural Kerala MPCE increased from Rs. 145.2 in 1983 to Rs. 1013.1 in 2004-05. In urban areas, Punjab shows a marked increase in MPCE (Rs. 184.38 in 1983 to Rs. 1326.00). On the other hand, the states like Bihar ranks the lowest position in MPCE in urban areas (Rs. 139.58 in 1983 to Rs. 696.27 in 2004-05).

Inequality in social category

The inequality in poverty rate is also visible among the sections belonging to different social categories. The graph given below shows the per centage point difference in poverty among population belonging to different social category. In rural areas, the difference of poverty rates between ST and Non-SC/ST in 2004-05 was 22 per cent point. This difference has not been reduced much since 1983. On the other hand the difference in per centage point between SC and non SC/ ST is 14.4 per cent point. In urban areas the difference between SC and non SC/ ST is 18.2 per cent point. For ST the difference is 11.6.

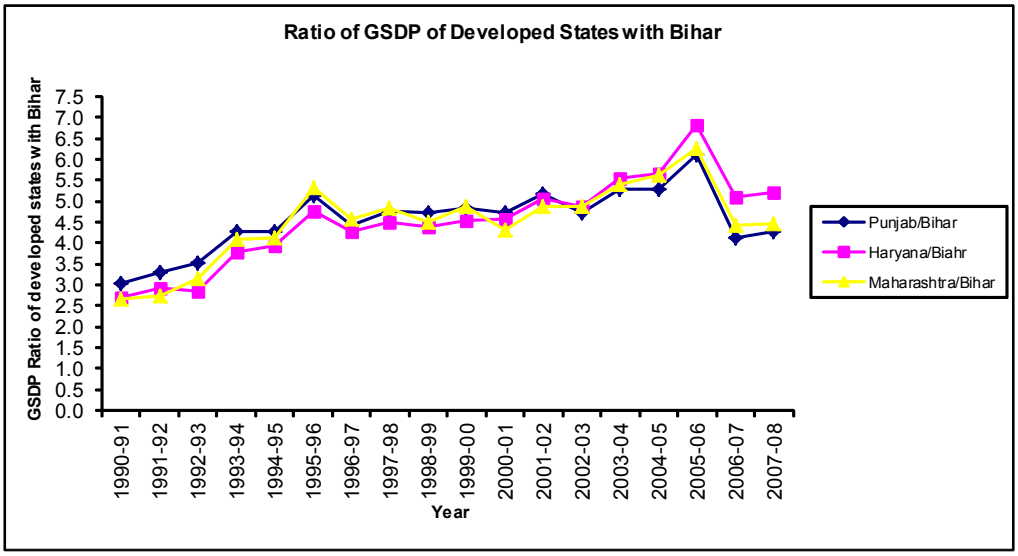
Graph 11.2: Difference in poverty rates between SC and ST with other caste population (1983 and 2004-05).



Source: Calculated from Table 11.4.

The per capita NSDP of major states given here shows a clear cut inequality among the states. The states like Haryana, Maharashtra and Punjab marked a good progress in terms of per capita NDP. On the other hand states like Bihar and Orissa lagged behind the developed states. In 1993-94, Punjab Maharashtra and Haryana have the PCNDP of Rs. 12710 and Rs. 12183 and Rs. 11079 respectively. On the other hand, the state like Bihar has a PCNNP of Rs. 3037 which is almost one fourth of that of Maharashtra and Punjab. Hence for both the time period, the per capita NSDP among the states show great inequality. The last two columns reflect the growth rate of per capita NSDP during 1993-94 – 1999-00. From 1993-94 to 1999-00 the state having a high growth rate includes Gujarat, Himachal, Karnataka, Rajasthan and Tamil Nadu. The poor performing states included Assam, Bihar, Jammu and Kashmir and Chattisgarh. In the 1999-2008 the well performing states included Uttarakhand, Kerala, Andhra Pradesh, Haryana, Gujarat and the low performing states included Madhya Pradesh, Punjab and Uttar Pradesh. Between the growth rate of two periods, the states like Orissa, Bihar and Uttarakhand registered a good progress. Bihar improved from 1.3 per cent growth to 5.4 per cent, Orissa from 2.7 per cent to 6.3 per cent and Uttarakand from 0.9 per cent to 7.1 pert cent of compound annual rate of growth. (per capita national domestic product)

Graph 11.3



Source: Calculated from data taken from National Account Statistics, MOSPI, http://mospi.nic.in/Mospi_New/upload/SDPmain.htm

The per capita GSDP of states shows a marked inequality in India. In the graph it has been tried to capture the inter-state inequality by plotting the ratio of per capita GSDP of developed states Punjab, Haryana and Maharashtra with the backward state of Bihar. This shows that the ratio of per capita GSDP of Punjab, Haryana and Maharashtra was respectively 3.0, 2.7, 2.7 times of that of Bihar in the year 1990-91. In 1995-96, the per capita Net State Domestic Product (NSDP) of the richest states like, Punjab, Haryana and Maharashtra increased to 5.1, 4.7 and 5.3 times respectively, higher than that of Bihar (the poorest state). In the year 2005-06 the inequality became highest at 6.1, 6.8, 6.3 times respectively higher than Bihar. The graph shows that the basic hierarchy of the Indian states remained the same during the reform period, with Punjab, Haryana and Maharashtra at the top, and Bihar and Orissa at the bottom. The graph also shows that gap between the richest and poorest states opened up considerably after 1990-1991. Income share of top 1 per cent of consumer expenditure groups to average consumption expenditure is 7 times higher in 2004-05 reflecting a high degree of inequality.

Inequality in non-income aspects

The story of inequality is not limited to only income and expenditure but also extends to other dimensions like health, education and economic assets such as land. India not only has high income inequalities, but also unequal outcomes in terms of how severely underweight children are distributed across rich and poor households.

In India, 5 per cent of the children are severely underweight among the richest 20 per cent households. In case of the poorest 20 per cent households, this share is 28 per cent. The distribution of land, one of the most important economic assets, in developing Asia is heavily concentrated. This is particularly true in the South Asian countries where income/expenditure inequalities are high. A similar phenomenon is seen in terms of access to public services like clean water, health facilities, sanitation, electricity and schools.

As per the data available from the National Family Health Survey a large inequality is found in the three anthropometry measures of child nutrition. The per centage of child underweight in rural and urban areas are 32.7 and 45.6 per cent respectively. This shows a 12.9 per centage point difference. Likewise a high inequality is also

found in case of underweight by mothers' education. About 52 per cent of children are underweight for the households having an illiterate mother, whereas 17.9 per centage of children are found underweight for mothers who had completed 12 years of education. Inequality in underweight is also visible by social category. A marked difference in the per cent of underweight children is found in the wealth quintile of households. Almost 56.6 per cent of children are underweight from the lowest wealth quintile as against 19.7 per cent of children from the highest wealth quintile.

The child mortality rate and institutional delivery are the two most important aspect of health services. A large inequality is found in mortality rate. The IMR among lowest wealth quintile households is 100 per thousand as compared to 34 per thousand from highest wealth quintile households. Likewise the IMR in terms of education of mother shows a marked difference. The IMR among households having an illiterate mother is 95 as compared to 30 for households having mothers who had completed 12 years of education. The inequality in IMR among social category and NFHS rounds is also visible from the table. The per centage of delivery under a health facility also shows a high inequality. Among lowest wealth quintile households, only 12.7 per cent have undergone delivery in a health institution as compared to 83.7 per cent from the highest wealth quintile.

Maternal care indicators for births, one of the important indicators of health, shows a marked inequality. The per centage of women who received anti natal care are 90.7 and 72.2 in urban and rural areas respectively. Again, the per centage of women who had at least three anti natal care visits is 73.8 per cent and 42.8 per cent in urban and rural areas respectively. The inequality can also measured in terms of vaccinasition of children. Only 26.1 per cent of children having illiterate mohers are fully vaccinated as against 75.2 per cent of children with mothers completing 12 years of education and above. Among households belonging to lowest wealth quintile the per centage of children vaccinated is 24.4 per cent as compared to 71.0 per cent in the highest wealth quintile.

In terms of sanitation, electricity and asset ownership a marked difference is visible in rural and urban areas.

The inequality among states in terms of non-income aspects is found to be stark. The infant mortality rate in India decreased to 47 in 2010 from 57 in 2006. The estimates of under-five mortality in 2010 survey range from a high of 44 in UP and Chattisgarh to a low of 13 in Kerala (Appendix 1). The trend in birth delivered in a health facility is shown in Appendix Table 2. In the matter of birth cases, health facility increased to 38.7 per cent from 33.6 in 1998-99. The difference between delivery from NFHS-2 to NFHS-3 is relatively high in states like Andhra Pradesh, Jammu and Kashmir, Maharashtra and Punjab. In NFHS 3, the rate is highest (99.3 per cent) in the state of Kerala in 2005-06 (although the rate was as low as 4.4 per cent during 1992-93 in the state). The mothers' education has a great influence in nutritional status of child. Among the child having an illiterate mother, the institutional delivery rate is as low as 19.8 per cent as compared to 80.6 per cent among child having mothers' education more than 10 years and more (Appendix 3).

Driver of inequality

First, there has been a relative neglect of the agriculture sector by policymakers. While economic development entails a move from the off-farm to industry and services, deficiencies of public investments in agriculture, and in the rural economy

more generally, has been problematic precisely because the productivity of agriculture determines the standards of living of majority of the people in India. A deterioration of public ethics, public institutions, and public administration has together resulted in significant leakages of public expenditures. As a result, there exist schools with errant teachers not allowing measles immunisation to rural areas, and non-delivery of child nutrition programmes. A lack of accountability on the part of governments officials for delivery of public social services also drives inequality.

Check Your Progress 2

1) How would you measure the quality of life?

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2) Give a profile of inequality in distribution of consumption expenditure during 1993-94 to 2004-05.

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3) State the indicators of inequality in non-income aspects of life.

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11.8 INCLUSIVE GROWTH

The traditional economists view that inequality is inherent in the process of growth. During structural transformation of the growth process, certain sectors are highly benefitted from the process and certain sectors lagged behind. So in the initial period, growth leads to inequality. But after the process, the benefits of growth are percolated down to the lagging sectors and ultimately that leads to a more equitable growth. This process is visible in 'Kuznet curve' where inequality first rise and then fall. However, this process was not found true in India as increase in growth rate did not inevitably resulted decrease in inequality.

Inclusive growth emphasises that the economic opportunities created by growth are available to all particularly the poor — to the maximum possible extent. We may thus define inclusive growth as growth that not only creates new economic opportunities, but also ensures equal access to the opportunities created for all segments of society, particularly for the poor. Thus Inclusive growth is the process that focuses on both creating opportunities rapidly and making them accessible to all including the disadvantaged.

Felipe and Hasan explain four features of Asian economy:

1) high output growth with low employment growth

2) wage differential between bottom and top quantile and between rural and urban areas increase,

3) employment in informal sector where productivity and wage are low is either in rise or persistently high. These factors are important in lagging opportunity. Hence creating opportunity is the first pillar. The second pillar is equalising opportunity. Despite the attempt to equalise opportunity through different measures, there will be some section of the society which are not enjoying the fruits of growth process.

Hence there needs to be the social provision through safety net. This is the fourth pillar of inclusive growth.

The **International Policy Centre for Inclusive Growth** (IPC-IG), is a partnership between the Poverty Practice of the Bureau for Development Policy, UNDP and the Government of Brazil. Located in Brasilia, IPC-IG facilitates South-South learning with the aim of expanding developing countries' knowledge and capacities to design, implement and evaluate effective policies towards the attainment of high inclusive growth. IPC-IG's work aims at equipping policymakers from developing countries with the skills necessary to formulate socially inclusive policies and to learn from successful policy experiences in the South. Strengthening capacity for policy analysis and implementation in the field through South-South learning is one of the services provided by IPC-IG to the development community and UNDP Country Offices.

The inclusive growth has extensively reflected in different plan period in India. In eleventh five year plan the GDP growth rate is likely to be of average 8.2 per cent as compared to 7.7 per cent of the 10th Plan. But despite an impressive growth in GDP, the country is lacking the achievement of inclusiveness. The 11th Plan defines inclusive growth to be "a growth process which yields broad-based benefits and ensures equality of opportunity for all". But this inclusiveness is not reflected as it was expected. We have seen progress on inclusiveness :Agricultural Growth, Poverty Reduction, Education, Health, Upliftment of Scs /STs etc. But however progress on inclusiveness is less than expected. It can be apprehended from different aspects. India missed achieving many indicators of millennium Development Goals (MDG). In the literacy front, the goal of increase in literacy among backward classes and other weaker sections has not been achieved. Agriculture growth is still in vulnerable conditions. The employment schemes like MGNREGS are not upto the mark. There are so many Plans, Policies, Schemes but their implementation is not according to their expected level.

As Govt. of India prepares to submit its approach paper for its 12th five-year plan, the Planning Commission's focus on instilling "inclusive growth" is making headway. The plan is expected to be one that encourages the development of India's agriculture, education, health and social welfare through government spending. It is also expected to create employment through developing India's manufacturing sector and move the nation higher up the value chain. Prime Minister Manmohan Singh, however, warned that maintaining fiscal discipline is important as well. An important aspect of generating "inclusive growth" is shifting the target of government aid to rural areas. The major aim of 12 five year plan are targeting GDP growth at 9.0 to 9.5 per cent range. An increase in literacy rates to 100 per cent between

the plan's period from 2012 to 2017, An increased expenditure on health from 1.3 per cent to 2.0 per cent of GDP. In its early stages, the 12th five-year plan promises a lot for rural development and growth. The Basic objective as stated in the Planning Commission is "Faster, More Inclusive and Sustainable Growth". It was said that the priority areas in 12th Five Year Plan would be Betterment of Farmers, Small Industries, Cottage Industries etc. It is asserted by the Planning Commission that growth need to be more inclusive.

The International Policy Centre for Inclusive Growth (IPC-IG), formerly the International Poverty Centre, is a partnership between the Poverty Practice of the Bureau for Development Policy, UNDP and the Government of Brazil. The IPC-IG facilitates South-South learning with the aim of expanding developing countries' knowledge and capacities to design, implement and evaluate effective policies towards the attainment of high inclusive growth. IPC-IG is a hub for South-South dialogue on applied research and training on development policy.

11.9 INCLUSIVE GROWTH – POLICY AGENDA

Agricultural Development

Agriculture development should be given priority. The recent trend shows that the contribution of agricultural sector to total GDP has reduced from 44.6 per cent to 17.2 per cent from the year 1958-59 to 2010-11.On the other hand, the absorption of labour in the agricultural sector has not reduced much during the same period. This shows that the pace of reduction of contribution of GDP to agricultural sector is extremely high as compared to pace of reduction of workforce in agricultural sector. Hence there is a need to develop the agricultural sector by way of irrigation and water management, credit, research and extension, marketing etc. Land and water management (including watershed development) are crucial for agriculture development. Development of agro based industries in rural areas has not only expanded the scope of employment but also reduced the heavy dependence on agricultural sector.

Public Investment

High investment in infrastructure is important for inclusive growth. In many developing countries it is visible that public expenditure as per centage of GDP is low and declining. As a result, public investment in rural development has declined sharply. Consequently agricultural growth slowed down in India. Priority to public investment in physical (irrigation, roads, communications, transport, electricity etc.) and human infrastructure (health, education etc.) is considered as one of the important factors responsible for inclusive growth.

Public Expenditure on Health and Education

There is a need to increase public expenditure on health and education. Effectiveness of these expenditures has to be improved. For example, expanded child and maternal immunisation, antenatal care coverage, nutritional supplementation (including promotion of exclusive breast feeding) and home based neo-natal services (including treatment of pneumonia) is likely to bring about significant reduction in both infant mortality and child malnutrition.

Development of Institutions

Development of institutions and strengthening the present institutions of service delivery are important. Several institutions seemed to have failed in delivering

better services particularly in health and education in rural areas. Institutions seem to be responsive when women are empowered. Decentralisation in terms of strengthening PRIs has to be improved in order to have better delivery systems.

Social Protection

The social protection system can play an important role in mitigating poverty and inequality through redistribution. This also helps to give the platform to the excluded section of the society. India has implemented a plethora of poverty alleviation programmes to address the issue of poverty and inequality. Most important programme is Public Distribution System (direct food subsidy), Indira Awas Yojana (Housing for poor) and direct cash transfer through the programmes like old age pension scheme, widow pension scheme, disability pension scheme, national family benefit schemes, etc. Some other programmes are also incentive based for example, incentives for institutional delivery, incentives for family planning, etc. For some of the educational development programmes like scholarship, free distribution of books, cycle, dresses, midday meal etc. are implemented.

From time to time the central and state governments implement different employment generation programmes which provides the minimum livelihood for rural and urban poor. The National Rural Employment Guarantee Act (NREGA) 2005, passed by the Government of India in August 2005, is a unique programme implemented by central government which guaranteed one hundred days of unskilled work per year on public works programmes to each rural Indian providing guaranteed employment entitled by law. Now, within fifteen days of a valid application, the government must provide work or unemployment allowance.

Check Your Progress 3

1) State the concept of inclusive growth.

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2) State how social protection can play an important role in mitigating poverty and inequality?

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11.10 LET US SUM UP

The unit deals with the nature and dimension of poverty and inequality and how the inclusive growth addresses these two issues. In general sense, poverty implies the lack of income/expenditure and the lack of access to basic needs like food, shelter, drinking water health etc.

Poverty is measured by the methods like head count ratio, poverty gap index,

squared poverty gap index by taking the income/expenditure. Several other non-income dimensions also play a major role in determining the level of poverty. The rate of poverty in India shows a reduction trend from 1973-74 to 2004-05. High growth with inequality has a common phenomenon of developing countries. How to tackle this lopsided growth with inequality is the major challenge. The inequality is measured by different methods like range, range ratio, coefficient of variation, and most importantly Lorenz curve. In India high inequality is found both in the income and expenditure and also in other non-income variables like IMR, underweight of child, literacy rate etc. Even geographical inequality also exists.

Inclusive growth not only creates new economic opportunities, but also ensures equal access to the opportunities created for all segments of society, particularly for the poor. Creating opportunity, equalising opportunity and providing the safety net are the main pillars of inclusive growth.

11.11 EXERCISES

1) What do you mean by poverty? Explain the indicators that cover income and non-income dimensions of poverty.

2) What do you mean by inequality? How are the inequalities of income measured in an economy? Also state the different indicators that cover inequality in non-income aspects of life.

3) Examine the policy implications of widespread poverty and inequality in the Indian economy.

4) "The quality of life in India is far from satisfactory." Comment.

11.12 KEY WORDS

Poverty Line : Poverty line is the income/expenditure cut-offs used to identify the poor from non-poor. This is the minimum requirement of an individual for a healthy living. The minimum requirement can include both food and non-food items.

Head Count Ratio : This is the simplest measures of calculating the incidence of poverty. This is the proportion of the population that is counted as poor. In other words the incidence of poverty is defined as the proportion of poor to the total population.

$$\text{Poverty HCR} = \frac{\text{No. of People below poverty line (Np)}}{\text{Total population (N)}} \times 100$$

Poverty Gap Index : This is a measure to identify the incidence as well as severity of poverty which derived from income or expenditure distribution. This measure shows how below the income/ consumption from poverty line.

Capability Poverty Measures : This is a multi dimensional measure of human deprivation developed by UNDP. The

indicator of this measure is the lack of being well nourished and healthy, the lack of capability for healthy reproduction,and the lack of capability to be educated.

Lorenz Curve : This is a graphical representation of the proportionality of a distribution. This is often associated with income distribution calculations and commonly used in the analysis of inequality.

11.13 SOME USEFUL BOOKS

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Appendix 11.1

Per centage of children under age five years classified as malnourished according to three anthropometric indices of nutritional status: height-for-age, weight-for-height, and weight-for-age, according to state, India, 2005-06.

State	Height-for-age (Stunting)	Weight-for-height (wasting)	Weight-for-age (Underweight)
Andhra Pradesh	42.7	12.2	32.5
Assam	46.5	13.7	36.4
Bihar	55.6	27.1	55.9
Chhattisgarh	52.9	19.5	47.1
Gujarat	51.7	18.7	44.6
Haryana	45.7	19.1	39.6
Himachal Pradesh	38.6	19.3	36.5
Jammu & Kashmir	35	14.8	25.6
Jharkhand	49.8	32.3	56.5
Karnataka	43.7	17.6	37.6
Kerala	24.5	15.9	22.9
Madhya Pradesh	50	35	60
Maharashtra	46.3	16.5	37
Orissa	45	19.5	40.7
Punjab	36.7	9.2	24.9
Rajasthan	43.7	20.4	39.9
Tamil Nadu	30.9	22.2	29.8
Uttar Pradesh	56.8	14.8	42.4
Uttaranchal	44.4	18.8	38
West Bengal	44.6	16.9	38.7
India	48	19.8	42.5

Appendix 11.2: Statewise IMR, 2006 and 2010

	2006			2010		
	Male	**Female**	**Person**	**Male**	**Female**	**Person**
Delhi	36	39	37	30	37	29
Haryana	57	58	57	48	51	38
Himachal Pradesh	45	55	50	40	41	29
Jammu & Kashmir	51	53	52	43	45	32
Punjab	39	50	44	34	37	28
Rajasthan	65	69	67	55	61	31
Uttaranchal	42	44	43	38	41	25
Chhattisgarh	59	62	61	51	52	44
Madhya Pradesh	72	77	74	62	67	42
Uttar Pradesh	70	73	71	61	64	44
Bihar	58	63	60	48	49	38
Jharkhand	46	52	49	42	44	30
Orissa	73	74	73	61	63	43
West Bengal	37	40	38	31	32	25
Assam	67	68	67	58	60	36
Gujarat	52	54	53	44	51	30
Maharashtra	35	36	35	28	34	20
Andhra Pradesh	55	58	56	46	51	33
Karnataka	46	50	48	38	43	28
Kerala	14	16	15	13	14	13
Tamil Nadu	36	37	37	24	25	22
India	56	59	57	46	49	47

Source: Economic Survey 2011-12; Sample Registration System 46; Dec. 2011, Office of Registrar General, Ministry of Home Affairs.

UNIT 12 EMPLOYMENT AND UNEMPLOYMENT: POLICY IMPLICATIONS

Structure

12.0 OBJECTIVES

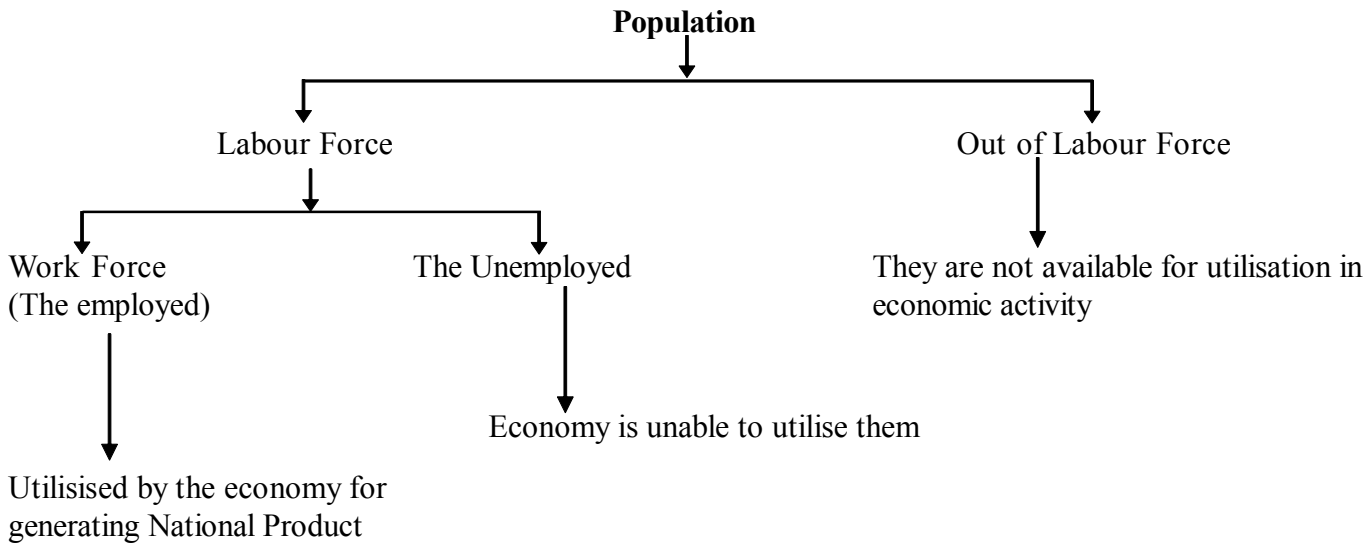
After reading this unit, you will be able to:

- know the various concepts used in the measurement of employment and unemployment by NSSO;
- explain the various dimensions of unemployment in India;
- examine the growth of employment in pre-reform and post-reform period;
- assess the quality of employment; and
- suggest various measures towards employment policy framework.

12.1 INTRODUCTION

Engagement of a person in any economic activity is central to the concept of identifying a worker. A worker is one who participates in any economic activity. His or her human capital endowment is utilised by the society (or the economy) and in the process, he or she earns a living. All workers constitute the workforce or the employed.

Those who are not workers are called non-workers. Some among the non-workers may be seeking or looking for work or are available for work. Such persons constitute the unemployed. The workforce and the unemployment together make up the labour force. The entire population of any area, region or country is, thus, made up of three components; the workforce (the employed), the unemployed and the non-workers. The third component is also referred to, for obvious reasons, as the population which is not a part of the labour force. The first is engaged in economic activity and produces the national product, the second is available for being engaged in such activity but the economy is unable to utilise it and the third is not available for utilisation in economic activity. Schematically, workforce can be illustrated as follows:



How are the workers or the employed and the other two categories of people in a given area – a region or a country, say India – identified and enumerated? How are the workforce and the labour force measured? We shall answer these questions in the next section.

12.2 ENUMERATION OF WORKERS

Now, let us discuss about the sources of data in India on workers. In India, two main organisations which generate and compile data on workers are the National Sample Survey Organisation (NSSO) and Office of the Registrar General of Census. These two organisations generate quite a substantial data on the workers, employment and unemployment etc. on regular intervals for the entire country. Within these two sources, NSSO provides more data on employment and unemployment.

For understanding and studying the data given in National Sample Survey (NSS) Rounds, it is important to be well aware of the concepts that are used in these data collection exercises. First of all, NSSO uses the concept of '**Usual Principal Status' (UPS)** as a time reference period for identifying workers. In more general terms, NSSO uses three reference periods to describe the activity status of a worker. These reference periods are – a year, a week and a day.

- The UPS identifies these reference periods of workers' activity status. More generally NSSO adopts a year as a reference period to identify the UPS status of workers. Taking a year as a reference period, NSSO identifies people as employed, unemployed or out of labour force. Thus, on the basis

of UPS of people, a person is known to be employed if he or she was engaged in an economic activity for a longer period of time (183 days or more) in 365 days. In the similar fashion, a person is known to be unemployed if that person is available for work but is not engaged in any economic activity.

- 'Subsidiary Status' – A 'subsidiary status worker' is that worker who was engaged in an economic activity in a subsidiary capacity during the reference period. The UPS employed and the subsidiary status workers together make single group of employed in the economy.

The reference periods (i.e. a year, a week and a day) are basically used to describe the period for which the workers are employed in the economy. These periods also help in identifying the nature and extent of unemployment in the economy. For example, NSSO uses the 'Current Weekly Status' (CWS) and 'Current Daily Status' (CDS) of the workers to elaborate the estimates of employment in an average week and an average day respectively.

The CDS criterion, thus, gives the estimate of the extent of underutilisation of the labour force in terms of person-days. In other words, the CDS estimate of unemployment is the most inclusive measure of unemployment made up of open unemployment and visible underemployment. In fact, the difference between the unemployment rates given by CDS criterion and CWS criterion gives the rate of visible underemployment.

The estimate of unemployed person-days given by the CDS criterion divided by 7 can also be interpreted as the estimate of the number of persons unemployed on an average day.

Similarly, these approaches lead to estimates of UPS employment, UPSS employment, CWS employment and CDS employment. The estimate of UPS employment represents the umber of persons who are employed for a relatively longer period of time during the reference year, or those who have stable employment. The UPSS criterion adds an additional group of persons to the UPS employed. These are UPS non-works who have done intermittent work as a subsidiary activity during the reference year. CWS employment refers to those who are employed for at least an hour during the reference week or the number employed in a average week. CDS employment measures the rate of utilisation of the labour force in terms of person-days. While the first three measures overestimate, to some extent, levels of employment because of the way they are defined, the CDS measure gives a closer estimate of these levels.

Creation of employment opportunities depends on the volume and composition of economic activity in the economy, that is, the total output of goods and services in the economy and its structure. The total output of goods and services is called the Gross Domestic Product (GDP). Thus, levels of employment in an economy depend on the size and composition of its GDP. Factors that affect this basic relationship are: (i) the availability of capital, (ii) the availability of skills and expertise among the employed persons and (iii) the manner in which capital and labour (the number of employment persons) combine to produce the output of goods and services. In other words, a number of inter-dependent factors like material, financial and human capital, knowledge and technology utilised, productivity of labour and capital and Government policies shape this relationship.

12.3 LABOUR FORCE AND WORKFORCE PARTICIPATION RATES

As stated in the previous section, Labour force refers to that segment of population which supplies or offers to supply labour for production and therefore includes both employed and unemployed persons.

Labour Force Participation Rate (LFPR) is a measure of the proportion of the country's population that is engaged actively in the labour market, either by working or seeking work. It provides an indication of the size of the supply of labour available to engage in the production of goods and services. The gap between average annual growth of labour force and employment growth provides hints towards increase/decrease in the existing stock of unemployed people.

Work Participation Rate (WPR) is a measure of the proportion of the country's labour force who are engaged in work. It provides information on the ability of the economy to generate employment.

Male participation remained higher both in labour and workforce, throughout the period between 1983 and 2009-10.

On CDS criterion, fluctuations are observed in the labour force participation rate in overtime. Using the usual principal and subsidiary status (UPSS) criterion, labour force participation rate was recorded to 42.9 per cent in 1983, declined to 42.3 per cent in 1993-94, and again increased to 43.0 per cent in 2004-05. Among women, rates were found to be 29.8, 29.0 and 29.4 per cent in the three years respectively. By usual principal status (UPS criterion) overall participation rates are lower: 38.4 per cent in 1993-94 and 39 per cent in 2004-05 and for women they were much lower at 21.1 per cent in 1993-94 and 22.4 per cent in 2004-05. Women are more often subsidiary workers then men: in 2004-05 male UPS participation rates was 55.1 and UPSS rates was 55.9 per cent, corresponding rates for women were 22.4 and 29.4 per cent respectively (India Labour and Employment Report, 2012, IHD, N. Delhi.)

Female participation *per se* in rural areas was much higher than in urban areas. Urban male participation rates (both labour force and workforce) were higher than rural male participation in 1999-2000, 2004-05, and 2009-10. (Table 12.1)

LFPR for rural males increased marginally in 2009-10 compared to 2004-05 while for urban males it actually declined. The most striking revelation of NSSO'S 66th round survey is the significant fall in female work participation rates (FWPR) between 2004-05 and 2009-10. Rural FWPR dropped to reach 20 per cent in principal status work/employment (UPS) and 26 per cent in usual (principal + subsidiary) status work (UPSS) in 2009-10. In urban areas too, FWPR has fallen substantially from 13.5 per cent in 2004-05 to below 12 per cent in the case of UPS employment and from close to 17 per cent to below 14 per cent in UPSS (Mazumdar, 2011). With principal status or main work/employment as well as subsidiary status or marginal work having both lost ground, it appears that relatively more durable work as well as shorter bursts of temporary employment have become less available to women.Two possible explanations may be offered for this decline: **firstly**, women have simply withdrawn from the labour market in India due to social conservatism. **Secondly**, more women are pursuing higher education resulting decline in women LFPR. However, decline in women LFPR across all age groups indicates that there must be some other factors inhibiting women from

participating in the labour market. The decline in the LFPR for women irrespective of age is possibly due to decline of overall employment opportunities compelling the women for withdrawal from the labour market.

Thus labour force participation rate as per centage of population has not remained fixed over a period of time. Specific participation rate changes overtime in response to economic, social and cultural factors. This is particularly true of women and children. Most women from poor households participate in the labour force, but they may withdraw from it with increase in household income and then join again at much higher level of income and also when they have acquired a certain level of education. So female labour force participation rate is observed to have a U shaped relationship with the per capita income level (India Labour and Employment Report, 2012).

Table 12.1: Labour force and workforce participation rates (CDS basis) (per cent)

	1983	1993-94	1999-00	2004-05	2009-10
Labour force participation rates (LFPR)					
Rural Male	52.7	53.4	51.5	53.1	53.6
Rural Female	21.9	23.2	22.0	23.7	19.7
Urban Male	52.7	53.2	52.8	56.1	55.6
Urban Female	12.1	13.2	12.3	15.0	14.1
Work Force participation rates (WFPR)					
Rural Male	48.2	50.4	47.8	48.8	50.1
Rural Female	19.8	21.9	20.4	21.6	18.2
Urban Male	47.3	49.6	49.0	51.9	52.2
Urban Female	10.6	12.0	11.1	13.3	11.7

Source: Various rounds of NSSO survey on employment and unemployment.

Check Your Progress 1

1) What are various measures of employment and unemployment?

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2) Do you think that CDS criterion is the most inclusive measure of unemployment? Why?

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3) Differentiate between worker, non-worker and unemployed.

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12.4 DIMENSIONS OF UNEMPLOYEMNT

The unemployment rate is the ratio of the number of unemployed persons in the labour force per thousand.

Based on the different criterion of measurement, the data relating to unemployment rate over a long period have been incorporated in Table 12.2. On CDS criterion unemployment rate is highest ranging between 6 per cent and 8 per cent (8.34 per cent in 2004-05 and 6.60 per cent in 2009-10). On UPSS criterion the unemployment rate is lowest fluctuating between 1.6 per cent and 2.6 per cent.

- The number of unemployed persons in India, at UPSS basis has increased from 7.37 million in 1993-94 to 9.17 million in 1999-2000 and further to 11.21 million in 2004-05. Consequently, the chronic unemployment rate as per centage of labour force increased from 2.18 per cent in 1993-94 to 2.48 per cent in 1999-2000 and further to 2.60 in 2004-05.

  At CDS basis, the number of unemployed persons increased from 19.07 million persons in 1993-94 to 35.95 million in 2004-05. The corresponding unemployment rate at CDS basis increased from 6.03 per cent in 1993-94 to 7.32 per cent in 1999-2000 and further 8.34 per cent in 2004-05.

- The unemployment rate both UPSS and CDS was lower in 2009-10, 2 per cent and 6.6 per cent respectively, but the absolute number of unemployed increased (NSSO, 66th Round Key indicators). Unemployment rate decreased for all workers in 2009-10 compared to 2004-05. Decline in unemployment in rural areas has been marginal and less than that of urban areas. However, this decrease in unemployment is not because of an increase in employment, rather it is a result of decrease in the number of people particularly women offering themselves to work.

Table 12.2: Unemployment rates (as per centage of Labour Force).

Year	UPS	UPSS	CWS	CDS
1972-73	3.80	1.61	4.32	8.35
1977-78	4.23	2.47	4.48	8.18
1983	2.77	1.90	4.51	8.28
1987-88	3.77	2.62	4.80	6.09
1993-94	2.56	1.90	3.63	6.03
1999-2000	2.81	2.23	4.41	7.32
2004-05	3.18	2.33	4.53	8.34
2009-10	2.50	2.00	3.60	6.60

Source: India Labour and Employment Report, 2012.

- Overall unemployment for rural areas according to usual status approach was around 2 per cent. Urban rates were higher than the rural rates except for the CDS approach in which unemployment rates for rural areas were higher (nearly 6.8 per cent).

- The unemployment rate obtained by any of the approaches was higher for females than for males in both rural and urban areas. With the longer terms rates varying between 6 and 8 per cent and daily rates over 9 per cent. Gender differences are much sharper in the urban areas.

- The unemployment rate has been very high among the youth in the labour force. On CDS basis, unemployment has been highest for the 15-24 age group, (11 per cent in 1993-94, about 15 per cent in 2004-05 and marginal

decline in 2009-10 i.e. 14 per cent) This age group constitutes about 21 per cent of the work force in 2004-05. This implies that new entrants in the labour market are much more prone to unemployment and account for a quite significant proportion of unemployed persons.

Table 12.3: Unemployment rates by broad age group.

Age Groups	1993-94	2004-05	2009-10
15-24	11.2	14.8	14.3
25-34	6.6	8.5	6.3
35	3.3	5.3	4.2
Total	6.0	8.3	6.6

Source: NSS Report 515.

- The situation in urban areas is more serious. In the case of male youth, the unemployment increased from 13.7 per cent in 1993-94 to 14.7 per cent in 1999-2000. It however declined to 13.7 per cent in 2004-05. The female unemployment rate remained between 19 per cent and 21.5 per cent during this period.

Thus the unemployment among the youth continues to be high.

- The incidence of unemployment at CDS basis among the rural agricultural households which constitutes the single largest segment of the poor labour households has increased from 9.50 in 1993-94 to 12.29 in 1999-2000 and to 15.26 per cent in 2004-05.

The high incidence of unemployment among the educated in general and women in particular reflects that the pace of creation of diversified employment opportunities is lagging behind the pace of expansion of education. The educational and training courses offered by the educational and training system and their curricular content is becoming increasingly irrelevant to the kind of employment opportunities being generated by the economy. Gender discrimination in the labour market and at the workplace also seems to be adding to the problem. These features of the unemployment situation call for steps like: (i) expansion and diversification of the economy, especially the rural economy, (ii) restructuring of the education and skill development system to make it responsive to the world of work and (iii) focus on removal of gender bias in the labour market, the workplace and in skill development.

12.5 GROWTH OF EMPLOYMENT

The available information relating to the growth of employment in India during the last three days is comprehensively summarised in Table 12.4 below:

Table 12.4: Average annual rate of growth of employment.

Year	Growth Rate
1983-1994	2.06
1994-2000	0.98
2000-2005	2.95
2004/05-2009-10	0.95

Source: Based on respective rounds of employment and unemployment survey reports.

i) There has been a sharp decline of employment in the growth rate of employment (UPSS) from 2.06 per cent per year in the period 1983 to 1993-94 to only 0.98 per cent in the period 1993-94 to 1999-2000. Although this decelaration in employment is accompanied by an equally sharp decline in the rate of growth of labour force from 2.29 per cent in the period 1987-88 to 1993-94 to only 1.03 per cent in the period 1993-94 to 1999-2000, yet the growth rate of employment has been less than the growth rate of the labour force. This indicates an increase in the unemployment rate.

ii) Employment growth during 1999-2000 to 2004-05 has accelerated significantly as compared to the growth witnessed during 1994-2000. During 1990-2000 about 47 million work (CDS basis) opportunities were created compared to only 24 million in the period between 1993-94 and 1999-00. Employment growth accelerated from 0.98 per cent per annum to 2.95 per cent per annum. However, since the labour force grew at a faster rate of 2.84 per cent than the workforce, unemployment rate also rose. The incidence of unemployment on CDS basis increased from 7.31 per cent in 1999-00 to 8.28 per cent in 2004-05.

Table 12.5: Average annual growth rate of employment: gender-wise in rural and urban areas.

Years	Rural			Urban			Total		
	Male	Female	Total	Male	Female	Total	Male	Female	Total
1983-94	1.77	1.15	1.55	2.75	3.18	2.94	2.05	1.41	1.84
1994-2005	1.32	1.46	1.37	2.94	3.34	3.03	1.76	1.75	1.76
2005-2010	1.24	–2.09	0.12	2.63	0.27	2.22	1.66	–1.67	0.67

iii) The employment growth during 2004-05 to 2009-10 was significantly lower than during 1999-00-2004-05. The pattern of employment growth reveals absolute decline in rural female's employment. In this period, both in rural and urban areas slowdown in employment growth for male has occurred. The sharp absolute decline for rural females and slight absolute increase for urban females is observed.

It is worth to be mentioned that this decline in employment took place when Indian economy was growing rapidly and National Rural Employment Guarantee Act, 2005 was implemented. Further, this decline of employment is accompanied by significant decline in the labour force participation rate (LBRF) particularly for women.

Table 12.6: Growth of employment (UPSS) (CAGR per cent per annum).

Sector	Growth Rate		
	1972-73/1983	1983/1993-94	1993-94/2004-05
Primary	1.67	1.21	0.62
Secondary	4.40	2.50	4.03
Tertiary	4.19	3.54	3.22
Non-Agriculture	4.46	3.12	3.48
Total	2.49	1.84	1.76

Source: Based on various NSS reports.

Table 12.7: Changes in sectoral shares of employment (UPSS) (per centages).

		Primary	Secondary	Tertiary	All
Rural	1983	81.80	8.60	9.50	100.00
	2004-05	73.00	13.20	13.80	100.00
	2009-10	68.60	16.70	14.70	100.00
Urban	1983	15.60	32.60	51.80	100.00
	2004-05	9.40	33.30	57.30	100.00
	2009-10	8.10	33.80	58.10	100.00
Total	1983	68.90	13.30	17.80	100.00
	2004-05	57.00	18.20	24.80	100.00
	2009-10	53.80	20.90	25.39	100.00

iv) There have been significant changes in the sectoral pattern of employment. The proportion of the work force engaged in the primary sector declined by 12 per cent between 1983 and 2004-05 and it showed faster decline between 2004-05 and 2009-10. There has been a change in the trend in favour of secondary sector. Thus at the aggregate level, favourable correction in shifting share of employment in favour of secondary sector is observed.

Between 1983 and 2005, construction and financial services witnessed the fastest growth in employment of about 6 per cent per annum fallowed by trade (4 per cent) and transport (4 per cent). Employment in other sectors including manufacturing and agriculture was slowest.

An interesting feature of employment growth is that improvement in employment conditions was very modest during 1999/00–2004-05(1st period) and very substantial during 2004/05–2009-10(2nd Period) because the Ist Period failed to induce significant movement of workers from the unorganised to organised sector. This failure, it can also be said, restrained economic growth, the wrong kind of change in employment structure made a negative contribution to the wrong kind of change in employment structure making a negative contribution of growth of output per worker and hence to growth. The modest improvement in employment condition in this period derived basically from modest but favourable change in employment structure within the unorganised sector.

In the second period, economic growth improved employment conditions by inducing large movement of workers from unorganised to organised sector. And this movement in them contributed to growth by increasing the average output for worker in the economy (Ghosh, 2011).

Check Your Progress 2

1) What are the implications of decline in women LFPR in 2009-10?

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2) Do you think that higher growth necessarily helps in expanding employment growth?

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3) Give an account of decline in unemployment rate in 2009-10 as compared to 2004-05.

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12.6 QUALITY OF EMPLOYMENT

Broadly, quality of employment can be judged on the following basis:

- Proportion of workers engaged in regular and casual labour;
- Productivity of employment;
- Proportion of workers in organised and unorganised workers.

Proportion of workers in organised and unorganised workers

Increasing share of employment in unorganised sector reflect deterioration in the quality of employment because workers' earnings, regularity of employment, work environment and social security vastly differ between organised and unorganised sector. Workers in organised sector have better wages and salaries, job security, reasonably decent working conditions and social protection against risks such as sickness, injuries, disability and death arising out of hazards, accident at works, separations and old age. Those in the unorganised sector apart from insecurity of job generally have no protection against these risks, have low earning, often lower than the modest statutory minimum wages and have no regularity. An increase in the share of unorganised employment obviously means an overall deterioration in the quality of employment.

An important aspect related to quality of employment is the large size of unorganised sector as against organised sector in the total employment. The size of the organised sector characterised by higher earnings and job security has declined from 8.83 per cent in 1999-2000 to 7.46 per cent on 2004-05. Corresponding share of workers in unorganised sector increased from 91.17 per cent im1990 to 92.38 per cent in 2004-05.

Even the organised sector is increasingly moving towards informal employment. The entire employment in the unorganised sector is informal as is clear from the following table.

Table 12.7: Distribution of workers by types of employment and sector.

(million)

Sector	1999-2000			2004-05		
	Informal	Formal	Total	Informal	Formal	Total
Unorganised Sector	341.28 (99.60)	1.36 (0.40)	342.64 (100)	393.47 (99.64)	1.43 (0.36)	394.00 (100)
Organised Sector	20.46 (37.80)	33.67 (62.20)	54.12 (100)	29.14 (46.58)	33.42 (53.46)	62.57 (100)
Total	361.74 (91.17)	35.02 (8.83)	396.76 (100)	422.61 (92.38)	34.85 (7.46)	457.46 (100)

Note: 1. UPSS basis.
2. Figures in brackets indicate per centages.

Source: National Commission for enterprises in the Unorganised Sector (UCEUS); Report on Conditions of Work and Promotion of Livelihood in the Unorganised Sector, 2008, New Delhi.

The landless labourers and marginal farmers engaged in agriculture are worst affected on this account. The non-form workers are equally affected by in formalisation of employment.

Table 12.8: Distribution of non-farm workers by types of employment and sector.

(million)

Sector	1999-2000			2004-05		
	Informal	Formal	Total	Informal	Formal	Total
Unorganised Sector	109.37 (99.04)	1.06 (0.96)	10.43 (100)	140.65 (100)	1.42 (100)	142.07 (100)
Organised Sector	17.58 (36.13)	31.08 (63.87)	48.66 (100)	25.89 (45.85)	30.58 (54.15)	56.47 (100)
Total	126.95 (79.80)	32.13 (20.20)	159.09 (100)	166.54 (8389)	31.99 (16.11)	198.54 (100)

Note: Figures in brackets indicate per centages.

Source: National Commission for enterprises in the Unorganised Sector (UCEUS): Report on conditions of Work and Promotion of Livelihood in the Unorganised Sector, 2008, New Delhi.

It is significant to note that the informality is generally linked to economic activity with low productivity and low income generating prospectus. Given the heterogeneity of informal employment, there is a need to formulate specific policy sets to find solution to informality traps.

Further it is relevant to mention that quality of life and formal employment are positively correlated with each other. The countries with very high HDI are having more than 80 per cent of their workers in formal employment. Most of the countries, with high HDI, are also having 60 to 80 per cent of their workers in formal employment. This proportion ranges between 40 to 60 per cent in most of the medium HDI countries. Compared to it, less than 20 per cent of the workers are in formal employment in almost all the countries with low HDI. Thus, social

security and quality of life are closely related with each other, higher the social security coverage higher is the quality of life, as reflected by HDI.

Productivity of Employment

In a developing country like India being employed does not necessarily ensure a decent level of living. There is a high incidence of working poor as is evident from the following table,

Table 12.9: Working poor in India by their gender, location and category of employment 1999-2000 and 2004-05.

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Population	1999-2000				2004-05			
	Self Employed	Regular Wage/ Salaried	Casual Labour	Total	Self Employed	Regular Wage/ Salaried	Casual Labour	Total
Rural Persons	32762	2457	41466	76686	33139	2273	31425	69537
	(19.39)	(11.62)	(36.34)	(25.21)	(16.08)	(9.30)	(30.34)	(20.27)
Urban Persons	9387	4201	7531	21120	12141	5302	7321	24765
	(23.60)	(11.10)	(43.96)	(22.29)	(22.87)	(11.49)	(41.90)	(21.22)
All Males	27728	5545	31602	64875	29135	5863	27388	62386
	(19.68)	(11.18)	(36.77)	(23.47)	(17.17)	(10.24)	(31.85)	(19.94)
All Females	14421	1114	17396	32931	16145	1713	14058	31916
	(21.27)	(11.84)	(38.41)	(26.88)	(18.03)	(12.83)	(31.99)	(21.74)
All Persons	42150	6658	48998	97806	45280	7576	41446	94302
	(20.19)	(11.29)	(37.34)	(24.52)	(17.47)	(10.73)	(31.90)	(20.51)

Source: GOI, Planning Commission (2008): Eleventh Five year Plan: 2007-12.

The number of working poor increased from 98 million in 1999-2000 to 94 million in 2004-05. The self-employed worker account for nearly 48 per cent of the working poor followed by casual labour (44 per cent) in 2004-05. However among the casual labourers, nearly 32 per cent were poor as compared to 17.47 per cent in the category of self employed. The proportion of poor, among all the three categories of working poor was least in the case of regularly employed workers.

It is significant to note that the incidence of poverty was higher among urban workers across the three categories. Similar was the case of females with a smaller difference.

Obviously, the major problem relates to that of the working poor as the productivity of employment is very low. The low productivity of employment is mainly because of low educational and skill levels of the workers. About 44 per cent of all workers were illiterate and another 22.7 per cent workers have schooling upto primary level.

However, the employment conditions in terms of employment structure (substantial movement of workers from unorganised to the organised sector) and large growth

of output per worker in the unorganised sector has improved during 2004-05 – 2009/10 in comparison to 1999/00 – 2004-05 (see following tables).

Table 12.10: Average annual rate of growth of output and output per worker (per centages).

	1999/00–2004/05	2004/05–2009/10
Output		
Aggregate economy	5.02	8.45
Organised Sector	5.78	10.39
Unorganised Sector	4.52	7.01
Output per worker		
Aggregate economy	2.63	6.74
Organised Sector	4.59	3.15
Unorganised Sector	1.98	6.06

Note: The data on output are derived from National Income Statistics.

Table 12.11: Accounting for growth in output per worker.

	Percentage of Increase in Output per Worker Attributable			
	Increase in Output per Worker within sectors		Change in Structure of Employment	
	1999/00–2004/05	2004/05–2009/10	1999/00–2004/05	2004/05–2009/10
Aggregate economy	117	70	–17	30
Organised Sector	96	109	4	–9
Unorganised Sector	41	92	59	8

Note: Change in the structure of employment means movement across organised and unorganised sectors in the case of the aggregate economy and across production sector (agriculture, manufacturing, construction, other industries and services) in the cases of organised and unorganised sectors.

Proportion of Workers Engaged in Regular and Casual Labour

Another dimension of deterioration in the quality of employment can be examined in terms of low earning, irregularity and uncertainty of work availability, poor condition of work and lack of social protection and vulnerability to the risks and hazards is seen in the increase in the casualisation of the work force.

In 2004-05 self employment grew significantly with a fall in casual employment and marginal rise in regular employment. In 2009-10, the proportion of self employed declined and it was lowest proportion for all workers since 1993-94. The decline of self-employment is the highest for female workers. The proportionThe Indian employment market is moving from regular to casual employment. The proportion of casual workers in total workers increased from 24.03 per cent in 1983 to 27-29 in 1999-2000, 23 per cent in 2004-05 and 33.5 per cent in 2009-10. The proportion of casual labour in rural and urban areas was 38.6 per cent and 17.5 per cent in 2009-10 respectively.

During 1983-2000, the proportion of self-employed declined from 58.84 per cent to 55.19 per cent and further increased to 58.83 per cent.

As regards, the share of regular workers, it declined from 17.14 per cent in 1983 to 16.35 in 1993-94 and 15.16 per cent in 2009-10.

The proportion of casual workers have increased significantly in the rural areas compared to 2004-05. This is due to implementation of NREGA.

As regards, the share of regular workers there has been a marginal increase in all category of workers.

Casualisation of employment does not assure adequate days of employment and income to meet the basic necessities of labour households. This along with low wage rates adversely affects growth rate of average daily wage earnings of the casual labour depriving them of fulfilling the basic needs.

Table 12.12: Distribution of workers by category of employment.

Year	Nature of Employment		
	Self employed	Regular/salaries	Casual
1983	58.84	17.14	24.03
1993-94	57.31	16.35	26.34
1999-2000	55.19	17.52	27.29
2004-05	58.83	18.13	23.03
2009-10	51.0	15.6	33.5

Source: Eleventh Five Year Plan upto 2004-05.
Key Indicators of Employment and Unemployment in India.

12.7 EMPLOYMENT POLICY FRAMEWORK

According to Bhaduri (2006), policy approaches for promoting employment in a growing economy could be categorised in three broad categories. These refer to a) strategy for using surplus labour through extensive growth; b) inter-sectoral transfer of labour out of agriculture induced by sectoral difference in labour productivity; and c) change in the pace and composition of industrialisation.

The conventional approach (a la Lewis model), has been to emphasise the role of sectoral transformation of workforce without recognising the scope and/or potential of alternative mechanisms that may effect employment growth in the economy. This has been echoed in a number of writings and policy formulations which raised serious concern over the stickiness of workforce despite the higher rate of economic growth in India [Bhalla, 2009; Rangarajan, et. Al; 2011]. The result is pro-active polices for raising labour productivity in agriculture irrespective of the absorption capacity of the economy in especially in the industrial sector. While sectoral transformation, given the low productivity and massive under-employment in agriculture sector in a country like India is fairly justified, the strategy often fails (as in the case of India) given the limited options for labour intensive industrial sector in a high growth economy as noted above. This is particularly true when the growth is aligned mainly to the global markets and capital investment thereby undermining the domestic demand especially at the low end [Bhaduri, 2006].

In a situation such as this, tightening of the agriculture (rural) labour market assumes special role, where the central thrust is on productivity enhancement rather than on expansion of employment opportunities in rural economies. Arguably, a situation such as this has been manifested by the observed decline in labour force along with slowing down in the addition to the workforce during the period of 2004-05

to 2009-10. Ironically therefore the productivity enhancement strategies in a labour abundant agrarian economy such as India, often resorts to policy options that substitute labour in agriculture [Nayyar, 2008; p.338] either by changing the cropping pattern, or by increasing the use of chemical inputs, or through mechanisation, which at time, nor always, leads to displacement of labour. Thus shrinkage, rather than expansion of employment opportunities, is seen as the mainstay of raising productivity growth in agriculture. In turn improved labour productivity in agriculture may lead to greater demand for industrial good and services, increase in export, and generating ingestible surplus, a part of which could be channelised to industry and service sectors that may possibly absorb the surplus labour from agriculture.

A trajectory driven mainly by high-productivity and high value-agriculture however, may face severe impediments arising out of environmental and poverty related factors. These refer mainly to weather related uncertainties, shrinking natural resource base (primary productivity of land and other resources), and the distress faced by the poor farmers who may be compelled to grow 'low value' food crops in order to meet at least part of the food requirements under the scenario of uncertainties ailing the food sector in the country and the world over 'FAO, 2008]. These constraints may get further aggravated under the climate change scenarios for, the trajectory of high productivity-high value agriculture would invariable imply intensive use of chemical inputs and also water. It is here that the singular emphasis on sectoral shift of labour force may face additional impediments, beside the generally low employment opportunities, especially of the 'decent type' in the industrial and service sectors.

It is, therefore, imperative that the growth strategy gets appropriately tuned to the third policy option i.e. altering the pace and composition of industrial growth and create greater space for agriculture not only as a traditional reservoir of labour for industrialisation, but also as a sector with greater flexibility of absorb labour and generate broad based or extensive growth [Bhaduri, 2006; p.85]. This of course, is not the same as 'agriculture first' strategy advocated earlier by a number of scholars [Johnston and Maler, 1961; Maler, 1976]. Here, the emphasis is not on sectoral priority. The idea is 'to combine the advantages of industrialisation and inclusive growth with extensive growth in agriculture achieved through better labour absorption and a higher participation ratio' [Bhaduri, 2006; p.85]. The central thrust here is that 'besides the issue of sectoral balance in any developmental strategy, the scope for increasing labour periodicity through reorganising agriculture, as different from shifting a part of the labour to other sectors, should be thoroughly assessed and explored. This substantiated by and a renewed recognition of the potential for surplus labour absorption and increase in labour productivity in agriculture and rural sector, quite apart from the strategy for intersecoral shift of workforce [Bhaduri, 2006; p.84]. The Green Growth perspective may further enhance the potential of the primary sector to absorb productive labour by reversing the process of factor substitution that was mentioned above.

It is, therefore, argued that a balanced approach such as this may open up a number of avenues for reorganising production and consumption, essentially by harping on the demand side dynamics that leads to significant increase in effective demand in the domestic market. It is at this juncture, one may find a substantial space for convergence between the perspectives on employment, environment and social dimensions as suggested by the sustainable development framework (Shah, 2011).

12.8 TWELFTH FIVE YEAR PLAN: EMPLOYMENT AND LABOUR POLICY

The employment strategy for the Twelth Plan must ensure rapid growth of employment while also ensuring an improvement in the quality of employment. While self employment will remain an important employment category in the foreseeable future – 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. This category has increased from 17 per cent of total employment in 1983 to 18 per cent in 2004-05. 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 33 per cent.

The above analysis implies that the success of labour policy should be seen in terms of the number of regular wage employment opportunities based on some form of a written contract between the employer and the employee, that is, an increase in the number of 'formal' jobs. The potential for creation of formal employment can be fully utilised by making appropriate changes in rules and procedures. It is often said that one of the obstacles to growth of formal employment in the organised sector is the prevalence of excessively rigid labour laws which discourage such employment. Steps should be taken for a greater flexibility in labour laws. Broadly, it is necessary to review existing laws and regulations with a view to making changes which would:

- Encourage the corporate sector to move into more labour-intensive sectors
- Facilitate the expansion of employment and output of the unorganised enterprises that operate in the labour-intensive sectors.

At present, the incentives and subsidies are so designed as to strongly penalise entrepreneurs for crossing a threshold size from a micro/small to a medium/large unit. The excise and other taxation policies need to be reviewed in this perspective.

Changes in policies also need to be examined in regard to:

- Linking incentives with the outcomes measured in terms of employment. For example, incentives are given to a wide range of production activities primarily with the objective of promoting employment and income of workers engaged in such activities. However, such incentives are hardly every calibrated against the benefits realised in terms of employment and wages.
- Regular wage employment, that is, formal employment, merits fiscal incentives. Such incentives already exist at a limited scale for the larger establishment, but are so designed as to make it difficult for medium and small establishments to benefit from these.

Changing labour laws is a sensitive issue and it is necessary to build a consensus. However, there are several changes short of hire and fire which should not present problems. These include:

- The locations and production activities that have a high potential for employment creation merit a differential treatment.
- Employment of women must be encouraged ensuring, *inter-alia*, the special needs that they may have by virtue of change in working hours (night shifts, for example) or the requirements of the family, for example, child care.

- Contract labour in the domestic tariff area merits encouragement, provided commensurate steps are taken too increase social security.
- Monitoring the implementation of labour laws, that is, the reporting system should be simplified and be permitted in an IT-friendly mode.

Even as steps are taken to increase the volume of formal or regular employment, it is also necessary to take steps to improve the quality of employment in the unorganised sector. NCEUS in its August 2007 Report has summarised, in the form of 13-point Action Programme, the main recommendations for the workers of Enterprises in the Unorganised/Informal Sector. These are presented in Box 12.1.

Unorganised sector enterprises mostly hire most workers who get released, or relocated, from crop agriculture (due to the reasons discussed earlier), and seek wage employment in the manufacturing or services sector. Any significant improvement in their income, and quality of employment, is feasible only if the institutional environment in the labour market makes it feasible for the formal sector to reach out to such workers on a decentralised basis rather than through a centralised plan programme. The large coverage (in terms of absolute numbers) through Provident Fund (43 million), Employee State Insurance (33.0 million) a variety of Welfare Funds (5.0 million), for beedi workers, for example) has been possible because the institutional framework created through the various Acts (P.E., E.S.I., Beedi Workers Welfare Fund, etc.) recognised a relationship of those employed on regular wage, with either the employer, or the specific formal commodity market that provides work to (that is, absorbs the output of labour put in by) the unorganised enterprises' workers.

As already argued, the creation of a formal relationship between the worker and the hiring establishment, in the regular wage employment mode, is a critical factor in improving the quality of employment of the workers hired by the unorganised enterprises. In this context, the work being done by NCEUS on: (i) the 'employment strategy' to be pursued in respect of, and through the, unorganised enterprises, (ii) the regime of labour regulations to attract the unorganised enterprise to give a formal recognition to the multitudes of workers hired by them, and (iii) to enable them to gain access to 'social security', is of paramount importance.

Box 12.1

A thirteen point Action Plan suggested by the NCEUS for Employment in the Unorganised Sector

A. Protective Measures for Workers

1) *Ensuring Minimum Conditions of work in the Non-Agricultural and Agricultural Sectors;*

   Two Bills, for agricultural workers and non-agricultural workers, that specify minimum conditions of work, including a statutory national minimum wage for all workers.

2) *Minimum Level of Social Security;*

   A universal National Minimum Social Security Scheme, as a part of a comprehensive legislation, covering life, health and disability, maternity and old age pension to protect the workers in the unorganised sectors.

B. Package of Measures for the Marginal and Small Farmers

3) *Special Programme for Marginal and Small Farmer;*

Revival of the targeted programme focusing on small and minor farmers, with an initial thrust in the areas wherein the existing yield gap is also considered high. A special agency or a co-ordinating mechanism should be set up if required.

4) *Emphasis on Accelerated Land and Water Management;*

Immediate priority to, and significant upscaling of programmes for land and water management. Revision of the priority sector landing policy to provide a quota for the micro and small enterprises.

5) *Credit for Marginal-Small Farmers;*

RBI to monitor, separately, credit to this segment, expansion in outreach of credit institutions in rural areas and a credit guarantee fund to obviate the need for collateral by the marginal-small farmers in accessing the institutional credits. A 10 per cent share for small and marginal farmers in the priority sector credit.

6) *Farmers' Debt Relief Commission;*

Central government to lay guidelines and provide 75:25 assistance for setting up State level Farmers' Debt Relief Commissions, in the States experiencing agrarian distress, natural or market related.

C. Measures to Improve Growth of the Non-agricultural Sector

7) *Improve Credit Flow to the Non-agricultural Sector*

Per cent	Sector and Sub-Sector/Purpose
18	10 per cent Small & marginal farmers and 8 per cent Other framers
10	4 per cent for micro enterprises with capital investment (other than land and building) up to Rs. 5 lakh & 6 per cent other micro and small Enterprises
12	12 per cent Loans up to Rs. 5 Lakh to the socio-economically weaker sections for housing, education, professions etc.
40	Total priority sectors lending

8) *Encouraging SHGs and MFIs for Livelihood Promotion;*

Measures to encourage growth of micro finance and SHGs in poor states and in the backward areas.

9) *Creation of a National Fund (NAFUS)*

Rs. 5000 crore initial corpus for an exclusive statutory agency to take care of requirements of micro and small enterprises in agriculture and non-agriculture sector that are presently not reached by SIDBI and NABARD.

10) *Up scaling Cluster Development through Growth Poles;*

Twenty five growth poles in the traditional industries clusters with incentives at par with SEZs.

Measures to Expand Employment and Improve Employability

11) *Expand Employment through Strengthening Self-employment Programme;*

Rationalisation and strengthening of the four major self employment generation programmes with 50 lakh annual employment generation target.

12) *Universalise and Strengthen NREGA*

Extension of NREG Programme to all districts.

13) *Increasing the Employability through Skill Development;*

On-job training cum employment-assurance programme to provide Rs. 5000 per person incentive to any employer willing to provide one year on-job skill enhancement training.

12.9 REPORT TO THE PEOPLE ON EMPLOYMENT 2010

The report provides a framework to understand the contemporary employment scenario. It focuses on key issues of generation of quality employment for the people seeking work. The issue of providing decent work, particularly to those who are excluded and marginalised in the labour market is a central concern of this report. The report highlights that employment growth along with equity and distributive justice can be a powerful instrument for achieving the national agenda of 'inclusive growth'. The report views employment as a primary means through which citizenship is made real for the people, the way in which the people acquire a stake in society, overcome the insecurities of old age and ill health and ensure a better future for children.

One of the central ideas of the report is – high economic growth and growth of quality employment reinforce each other. Recognising low level of earnings and poor working conditions of casual labourers and a part of self employed workers, the report argues for increasing the share of organised sector employment in total employment of the country, particularly in the manufacturing and service sectors.

The report firmly puts on the agenda to best utilise the 'demographic dividend' by focusing on generating gainful employment for youth, in general, and young women, in particular. The report notes that given very low proportion of skilled workers at present, a suitable and workable framework to enhance the employability of workers is essential. The same can be achieved by providing training to workers at various levels with emphasis on recognising local skills and certifying informally acquired skills along with the expansion of skill development institutions. The report also argues for rationalisation of labour laws and broadening the ambit of labour reforms for achieving equitable employment growth. It sets out short-term and medium-term strategies to ensure gainful employment opportunities for all the working people with particular emphasis on the disadvantaged sections.

Major short term strategies and targets include: Employment growth to be targeted at least at 2.5 per cent per annum compatible with the 9 per cent growth in the economy; Promote labour intensive and high employment elasticity sectors to achieve the quantitative employment growth target; Focus on inclusion of youth, women and vulnerable groups with their specific needs of training and skill development; Statutory provisions to provide social security and improved conditions of work and remuneration of contract workers at par with the regular employees; Expand the outreach of Rashtriya Swasthya BimaYojana (RSBY) scheme to all poor households; Re-skilling the retrenched workers for redeployment; Developing Informationbase and e-monitoring on real time basis; and collection and compilation of employment/unemployment data on annual basis regularly.

Key Medium term strategies and targets are: Focus on self-employed and casual workers for improving livelihood; Enhance the scope of employment in the organised sector; Enhance regular employment for less advantaged groups and in poorer states; Comprehensive coverage of unorganised sector workers under social security schemes; Rationalisation and simplification of labour regulations and broadening the ambit of labour reforms, Promote diversification of rural workforce to off-farm and non-farm activities; Target regions with concentration of vulnerable social groups such as ST, SC, minorities, women, illiterate and less skilled for active labour market policies; Detailed skill mapping mechanism to be evolved, Credible and independent accreditation and certification process to be created; Up-gradation of all training providing institutions and strengthening delivery through public private partnership (PPP) mode; Creating large number of skill development institutions and poor of trainers to expand the outreach of skill development initiative; Setting up of Sector Skills Council; and Development of National Vocational Qualification Framework.

Check Your Progress 3

1) State the various dimensions of deterioration in the quality of employment in India.

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2) State three important features of employment policy approach as advocated by Prof. Bhaduri.

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3) Which measures would you like to suggest to generate employment opportunities for those already unemployed?

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4) State the central ideas of the Report to the People on Employment 2010.

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12.10 LET US SUM UP

The population of any area, region or country is made up of three components: employed, unemployed and non-workers. Employed and unemployed together make up of labour force. Three reference periods (i.e. a year, a week and a day) identify the nature and extent of employment and unemployment in the economy. Based on these three reference periods, three approaches are adopted in estimating the status of employment and unemployment — Current Daily Status (CDS), Current Weekly Status (CWS) and Usual Principal Status (UPS).

In comparison to 2004-05, unemployment rate declined during 2009-10 for all workers in rural and urban areas. However, this decrease of unemployment is not because of expansion of employment opportunities. Rather it is due to decline in the number of people particularly women offering themselves to work. Decline in the employment growth in 2009-10 highlight the point that even the rapid growth and National Rural Employment Guarantee Act, 2005 have not been able to sustain the generation of employment opportunities.

The quality of employment which is reflected from increasing size of unorganised sector in employment, rising number of casual and contract workers and lower productivity of employment has deteriorated over a period.

However, the employment conditions have improved in terms of employment structure (substantial movement of workers from unorganised to the organised sector) and increase in the real wages of the workers. Further increasing importance of non-farm sector in offering employment to rural work force across major states of India reflect the positive aspect of employment situation.

Policy approaches for promoting employment in a growing economy can be put under three broad categories:

a) strategy for using surplus labour through extensive growth; b) inter-sectoral transfer of labour out of agriculture induced by sectoral difference in labour productivity; and c) change in the pace and composition of industrialisation. Among these three alternate approaches, i.e. increasing labour productivity through reorganising agriculture deserves serious consideration.

12.11 EXERCISES

1) Distinguish between labour force and work force. How are the employed workers identified and enumerated in India? Also examine the dimensions of unemployment in India.

2) State the various dimensions of deterioration in the quality of employment in India. Also examine the policy implications of slowdown in women's workforce participation rate.

3) Critically evaluate the employment policy embodied in the eleventh Five Year Plan. Also state the conditions necessary for the success of this policy.

12.12 KEY WORDS

Underemployment : Underemployment means people who are employed for only part of a day or part of the week and unemployed for the remainder of the day or the week. This is underemployment that is visible.

Incidence of Unemployment : It is the share of the total unemployed persons in total labour force, expressed in per centage terms.

Human Capital Endowment : Human Capital Endowment is the capability, innate and acquired, of a person to earn income for living, which is over and above the costs involved in carrying out that effort.

Own-account Worker : Own-account worker is another name for self-employed workers.

Usual Principal Status Activity (UPS) : An activity on which, a worker is engage for a relatively longer period during one year, preceding the date of survey.

Employment Elasticity : The ratio of employment growth to the growth of National Income.

12.13 SOME USEFUL BOOKS

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Ghosh, Ajit K. (2011): '*The Growth-Employment Interaction in a Developing Economy,'* V.B. Singh Memorial Lecture delivered in the 53rd Annual Conference of The Indian Society of Labour Economics held in Udaipur.

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UNIT 12 ENVIRONMENT AND SUSTAINABLE DEVELOPMENT

Structure

12.0 OBJECTIVES

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

- Summarise the evolution of the meaning of 'development';
- Explain what 'sustainable development' means and how it is a part of any meaningful development process;
- State the notion of 'carrying capacity' and how sustainable development involves respecting the carrying capacity of ecosystems;
- Outline methods by which the process of development can become sustainable;
- Identify the main issues relating to sustainable development for some of the major sectors of the economy;
- Describe two of the strategies that can be applied to projects, activities and policies to work towards making them more environmentally friendly.

12.1 INTRODUCTION

"Development" is a major objective of governments and societies across the world. Countries and societies have, for many years, been classified in terms of their state of development as underdeveloped and developed and then as developing and developed. More recently, the terms "south" and "north" are being used to categorise "developing" and "developed" countries respectively. Nevertheless, whatever the language, the primary preoccupation is with the status of development.

The term 'development' actually refers to a process rather than a state of reality, and even the term developed is misleading for it suggests that the countries so described have reached a stage such that no further development is required. However, this is not true and all societies and nations, however developed, can develop further and are only developed in comparison to those less developed than them.

The notion of development has had an interesting history. When it first began being used to describe countries, it referred almost exclusively to the levels of economic development or growth that had been achieved. Therefore, countries were considered developed in direct proportion to how rich they were in economic terms. European countries, with many colonies and, consequently, with large revenues, were described as more developed than those which did not have colonies and, consequently, were economically poorer.

However, at the turn of the century and especially after the First World War (1914-1918), many people began to question this understanding of 'development'. It was felt that economic growth alone could not be considered development unless it promoted equity. Consequently, a country that had, as a part of its 'empire', colonies that were impoverished, could not be considered developed. Similarly, if within a country, the wealthy were few and the many poor, then again such a country could not be considered developed, even if its wealth was very great.

In recent times such thinking has been translated into what are known as social or human development indicators, which include education, health, sanitation, access to drinking water, nutritional levels, and civil rights. The United Nations Development Programme (UNDP) now brings out a Human Development Report that ranks countries in terms of their development status with regard to these various social and human indicators.

In the 1960s, another type of concern started being expressed about the definition of development. With the growing realisation of what we were doing to our natural resources, people started questioning whether a country could be considered developed if its economic growth was based on the destruction of nature and natural resources. Considering natural resources are the most fundamental of resources, even more fundamental than financial resources, any process of growth which destroyed these resources is bound to fail in the medium to long run. Such a development strategy is not likely to be sustainable. The destruction of natural resources may result in development of present but the future of the economy is in jeopardy. Out of such realisations has grown the notion of sustainable development.

Development therefore was redefined to mean only that economic and social growth that was equitable and that could be sustained over time. The term "sustainable development" began to be used to distinguish between the old idea of development and the new, sustainable, one.

Sustainable development has been described as development which:
"...meets the needs of the present without compromising the ability of future generations to meet their own needs." (Our Common Future 1987)

12.2 CARRYING CAPACITY

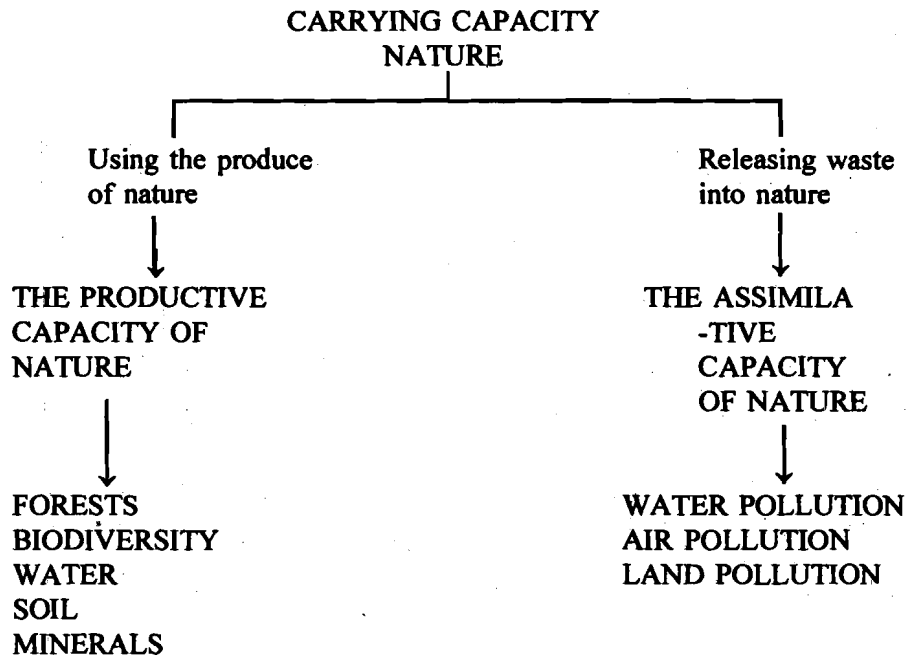
To fully understand what sustainable development means, we must first understand the notion of carrying capacity. The carrying capacity of an organism or a system is its ability to meet demands and withstand pressures without doing permanent damage to itself or compromising its ability to meet future demands and withstand future pressures.

For an ecosystem, this could mean its ability to tolerate extraction (its productive capacity) and withstand pollution (its assimilative capacity) without getting degraded.

To understand this better, consider that even human beings have a carrying capacity. We can donate only those amounts of blood safely that our body can replace in a short time. Similarly, we can assimilate a certain amount of caffeine or other pollutants, without they permanently damaging our health. However, if our body was drained of blood or if we were exposed to the type and quantity of pollutants that were beyond our ability to assimilate, then we would not only seriously injure ourselves, but in extreme cases also die. In any case, our ability to produce and function would be impaired. If this draining and polluting our body continues over time, we are very like to die.

A similar thing happens in nature. For example, take a river. The river has an ability to function without permanent damage even if a certain amount of water is withdrawn from it and taken for human consumption. However, if we drain the river of most or all of its water, then the river, as an ecosystem, dies or gets permanently damaged. Also, a river has the ability to assimilate some pollutants and to biodegrade them so that they do not damage the ecosystem. However, if we dump the types or quantities of pollutants that are beyond the assimilative ability of the river, then the river gets seriously damaged and even dies.

The diagram below shows how we interact with nature and assess its carrying capacity:

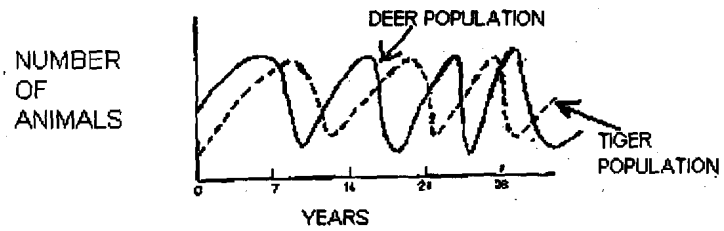


Therefore, one way of ensuring sustainable development is to ensure that the process of economic growth does not take from nature more than it is able to regenerate, and does not pollute nature beyond its ability to assimilate.

The carrying capacity of a resource is not finite. Through better management and technology, the carrying capacities of various natural ecosystems can be enhanced. For example, through the application of genetic engineering, mainly in the form of better seeds and faster growing strains of crops, the productivity of cultivated plants and of the land on which they grow can be increased. The application of fertilisers and irrigation can also enhance the productivity of land. Similarly, the assimilative abilities of an ecosystem can also be enhanced. Recently, there have been successful experiments with earthworms - called wormiculture - where the introduction of earthworms in compost pits can significantly enhance the ability of the ecosystem to break down the waste matter and assimilate the biodegradable substances, consequently enhancing the quality of the soil.

Human beings are perhaps the only living creatures on Earth that have the ability to exceede the carrying capacities of ecosystems to a point where these ecosystems get degraded or destroyed. In the rest of nature, there are in-built checks and balances to prevent the over-utilisation of natural resources. The consumption of resources by animals is determined by the availability of such resources.

So, for example, if the number of deer in a particular area increase to a point where they start consuming more grass than can be regenerated, then the availability of grass goes down and this, in turn, adversely affects the population of deer. Similarly, if the number of tigers in an area increases to a point where they eat up the other prey animals faster than these animals can reproduce, then, very soon there is not enough food for these tigers and their population begins to decline. Their population rapidly reaches a point where the balance between their population and the population of the prey animals is restored without any permanent damage being done. This cycle is endlessly repeated. The diagram below explains this relationship.



Also, in nature, nothing is waste. The 'waste' of one creature is the food of another and is finally an input to one part or another of the ecosystem. Therefore, a whole host of insects and microorganisms live in and off the excrement of various animals. These insects and microorganisms break down (biodegrade) this excrement to a point where it becomes nourishment for the soil. Similarly, dead plants and trees and even the carcasses of animals, become homes and food for other creatures who, in the process, help them to be assimilated by the ecosystem.

Only human beings, because of the rate at which they consume, the technologies that they have developed for facilitating consumption, and the nature and quantum of the waste they throw out, have a tendency of exceeding the carrying capacity of the ecosystems they depend on. The problem is aggravated by the fact that human beings have the ability to immunise themselves from the consequences of degrading their immediate environment by transferring their attention to other, remote, ecosystems, once their immediate ones are destroyed. Therefore, it is important to devise ways and means by which the interaction of human beings with the rest of nature is kept at sustainable levels.

Check Your Progress 1

1) What do you understand by the term "carrying capacity".

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2) How can the carrying capacity of natural ecosystem be enhanced?

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12.3 SUSTAINABLE DEVELOPMENT

Sustainable development is not something that can be achieved overnight. The path to sustainability is through ensuring that every project, every activity, every scheme and every policy is progressively made environmentally friendly till it itself becomes sustainable and promotes overall sustainability. Given below are some of the issues, listed sector wise that need to be focussed on in our search for sustainable development

12.3.1 Forestry

Sustainable development within and through the forestry sector means that we should harvest from forests only that much of timber and non-timber produce that it can regenerate. So, for example, if a forest grows at the rate of 2 % a year, our harvest should never be greater than the increment. This is similar to the principle of judicious financial management where people are expected not to eat into the capital of their savings but live off its interest.

Take not from the capital of nature, but only from its interest.

What we take and how we take is also important. For example, if we harvest the young and growing trees, then in the long term, the forest will die. Similarly, if we concentrate our harvesting on only one part of the forest, then even though overall we might not have extracted more than what is regenerated, the area from which we have over harvested might become barren.

12.3.2 Biodiversity

Biodiversity or biological diversity is defined as the variability of ecosystems, species and genes. It is now recognised that the maintenance of biodiversity is critical for human well-being and survival.

There are many types of ecosystems on earth. For example, there are the seas and oceans, rivers and lakes, forests, deserts, grasslands, islands, and mountains. Within these categories, there are sub-categories. In India, for example, there are sixteen major types of forests and hundreds of subtypes. Similarly, there are tropical oceans and temperate oceans; there are cold and hot deserts and various types of mountain ranges and grasslands. Biodiversity at the ecosystem level means the variability of ecosystems.

Within each ecosystem, there are various species. Human beings are one such species, but there are others like tigers, lions, elephants, peepal trees, deodar trees, gulmohar and neem trees, peacocks, crows, bees, flies, etc. Biodiversity at the species level means the variability of species.

Within each species, each individual is different. Among human beings, for example, though we are all of one species, each one of us is physically and mentally different from the other: genetically variable. There are similar variations among individual members of all species. Biodiversity at the genetic level means the variability of individuals of the same species.

Conservation of biodiversity implies ensuring that the variability among ecosystems, species and genes does not become less than what is natural and that, in any case, no ecosystem or species becomes extinct.

There are many reasons why it is important to conserve biodiversity. Some of the major ones are described below.

Medicine: a large proportion of the medicines that are used in the world, especially the non-allopathic ones, are derived from plants and animals. Yet, we have only investigated about one percent of the known species for their medicinal and other values. And of the species likely to exist on earth, perhaps only twenty percent have so far been discovered and identified. If specie that has either not yet even been identified, or whose medicinal and other uses have not yet been investigated, becomes extinct, then the cure to some of the diseases that are currently plaguing the world, like AIDS and cancer, might be lost for ever.

Even if species that we have already investigated and found to be of no use, becomes extinct, there are grave dangers. For, though these species might be of no use in curing the ailments we know about today, what is the guarantee that some new diseases might not appear in the future, just as AIDS did some years back. And then we might discover that its cure died with the extinction of the species that we thought was valueless. Therefore, in order to ensure that our options are not foreclosed, we need to ensure that each and every species is conserved. This is the option value of biodiversity.

Agriculture: All the plants we cultivate or the animals we domesticate, are derived from wild species. In order to keep open the option of developing new strains for cultivation and domestication, we have to ensure that wild species are conserved. Also, if cultivated or domestic strains have to be immunised against pests or diseases, then most often wild species have to be used to create such immune strains.

Biotechnology: This is a new area, which perhaps offers the greatest promise, among all technologies, to provide answers to some of the major problems facing the world: those of poverty, hunger and disease. However, the 'raw materials' of biotechnology are wild plants and animals. It is from the various plants and animals that genes can be found which, through genetic engineering, give new hope of solving many of the old problems. For example, the green revolution in India was a result of genetic engineering and, whatever might be the problems with it, has certainly raised the productivity of food grains in India. However, if species in the wild became extinct, then this 'raw material' of genetic engineering would no longer be available. We, therefore, must keep this option open also.

Web of life: All life is interconnected like the web of a spider. Each species is directly or indirectly dependent on all others. Therefore, if one species becomes extinct, then this affects all the species. The effect might not be felt immediately, but eventually the chain reaction starts.

For these and other reasons, it is important that biodiversity is conserved if development has to be sustained.

12.3.3 Agriculture

The soil and water resources that are a basis for agriculture, also need to be sustain -ably used. Soils are susceptible to wind and water erosion and to degradation. When the vegetative cover on soils is destroyed, the binding that such a cover provides to the soil is removed. These exposed soils become prone to erosion. Further, with the removal of vegetative cover, the soils get exposed to the direct rays of the sun and dry up quickly. This also lowers their productivity and makes them susceptible to erosion. The leaf and vegetative litter that is generated by the green cover enriches the soil and provides it with humus. When the vegetative cover disappears, the soils also degrade.

Cultivation and ploughing on slopes, without adequate measures to prevent soil erosion also aggravates the loss of soils. Another factor that degrades soil is unsuitable cropping patterns. If the soils are not allowed to rest adequately between crops, they loose their productivity. Also, if the nutrients of the soil are not replenished through natural fertilisers, the soil degrades.

Though chemical fertilisers can, for a short time, enhance the productivity of soils over a long period, they are not able to replenish all the trace elements in a soil and therefore cannot sustain long-term productivity. Eventually, more and more chemical fertilisers have to be applied to support a declining productivity. This not only reduces productivity but also significantly raises the financial costs of cultivation.

The over use of chemical pesticides or the use of inappropriate pesticides, also degrades the soil. Such pesticides, apart from killing crop pests, also kill the various insects, birds and microorganisms needed for regenerating the soils. The residues of such pesticides find their way into the water and the atmosphere, significantly degrading the environment and adversely affecting human health. If applied carelessly, they also contaminate the crops and become an additional health hazard.

Water logging is another threat to soils. Whereas this problem would be discussed in detail in the section on irrigation, suffice it to say here that large tracts of productive lands have become fallow because of salts and alkali contamination caused by rising ground water tables.

Deforestation in the catchment areas also results in floods and droughts, further compromising the productivity of our soils. Where catchments are denuded of their forest and other vegetative cover, the soils become susceptible to wind and water erosion. The summer sun dries them and when the rains come, they all flow down with the water. The lack of vegetative cover on the slopes also results in very rapid water runoff resulting in inadequate recharging of the underground aquifers. This means that where catchments are degraded, there is much greater water in the streams and rivers in the rainy season then there was when the catchments were vegetated. In addition, the topsoil and other debris, which was stabilised on the hillsides by the vegetation also now flows off the barren landscape. The resulting volume of water and silt is too much for the riverbeds to contain and so there are floods.

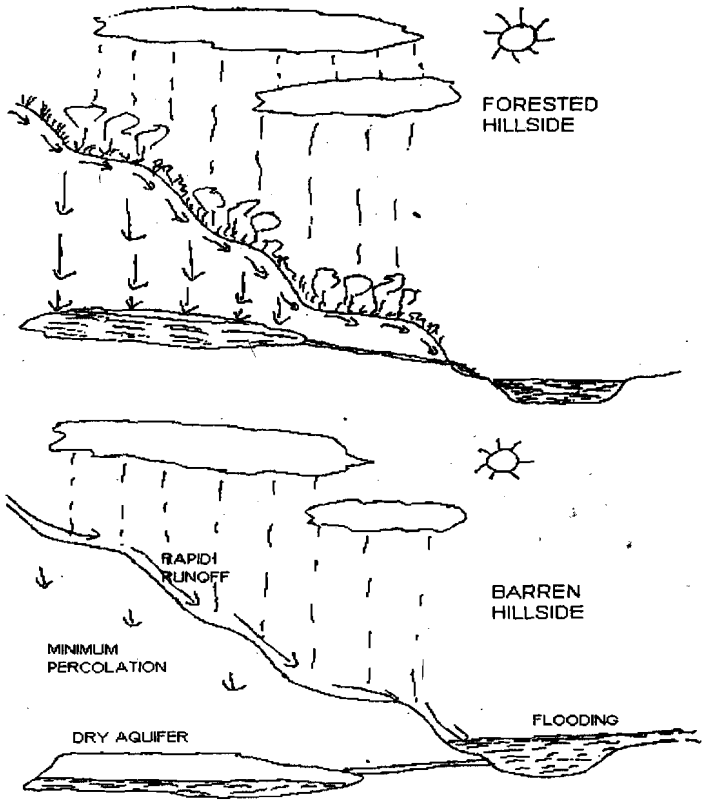
Also, as this silt reaches the plains and the river slows down, the silt sinks to the bed of the river, silting it up. This results in the capacity of the riverbed becoming less so that even normal flows of water cannot be contained and there are again floods.

Conversely, in the dry season, as the aquifers have not been properly recharged, there is little water in the streams and a drought occurs. Initially floods might enhance the quality of land in the flood plains, as they bring down the topsoil from the catchments. However, in a few years, all the topsoil has been eroded and only rubble is deposited. This significantly lowers the productivity of soils (see figure on next page).

Another threat to sustainable agriculture is the destruction of wild biodiversity. All the plants we cultivate today are derived from the wild. In the case of hybrid varieties, like the green revolution varieties, the cultivated strains are derived from the genes of wild plants. In order to ensure food security and to keep open the options of developing new strains of cultivable plants, we need to ensure that wild plant varieties are conserved. We also need the wild varieties to meet threats to our existing cultivable varieties (for details see section on biodiversity).

12.3.4 Water Resources

Water is, after air, perhaps the most critical human resource. The location of human settlements, throughout history, has more often been determined by the location of water sources than by any other single factor. And historically many societies and cultures have perished because they could not manage their water resources properly.



Water is essentially a renewable resource, much of it subject to yearly or half yearly cycles. The water (or hydrological) cycle moves water from one place to another and changes some of it from one form to another. The monsoon winds pick up moisture from the Indian Ocean and distribute it, as precipitation, throughout the country. In this process, they also convert salt water into fresh water. There is also the melting of snows and glaciers, in the Himalayas, which feed many of our rivers.

To ensure that water is sustainably used, it has to be ensured that the hydrological cycle does not go awry. This involves, to start with, ensuring that rainfall patterns do not get disrupted. Though the relationship between deforestation and macro climatic changes is not yet well understood, there is good evidence to believe that deforestation can cause serious disruption in micro rainfall patterns.

But, more important, the degradation of vegetative cover in the catchments seriously disrupts, as already described, the water cycle and causes floods and droughts. Deforestation and degradation of the upper reaches of the Himalayas also causes micro climatic changes, which affect the ice and snow, melt regimes, thereby disrupting the hydrological cycle.

So, the first task is to ensure that water is available where required, in the right quantity and at the right time. The second task is to ensure that this water is clean and wholesome. Ordinarily, the water that comes down as rain or through ice or

snow melt is pure and not polluted. However, certain types of air pollutants can contaminate rainwater even before it reaches the ground. A common result of such pollution is called 'acid rain'. Acid rain occurs when the atmosphere is polluted with sulphur dioxide and nitrogen oxides, which mix with rainwater to form sulphuric acid and nitric acid. Such rain, instead of nourishing the soil and vegetation, destroys them. Thousands of hectares of forests in Europe and North America have been 'burnt' by acid rain. The soil there has become acidic and lost much of its productivity and the lakes and rivers have been polluted, resulting in extensive fish kills.

Apart from atmospheric pollution, water is also subjected to pollution on the ground. Silt, domestic wastes, agricultural run off and industrial wastes pollute our lakes, streams, rivers and even the ocean. Such polluted waters become unfit for most human uses. Due to rampant water pollution in India, most of the surface water is unfit for human consumption. Much of it is also unfit for bathing and some of it even for agricultural use. When polluted water is fed into industries, there is a danger that it would damage the machinery or otherwise adversely affect the industrial process. Polluted water also degrades the environment, particularly affecting the fauna and flora that either live in that water or partake of it.

Water is stored or conveyed on the surface of the earth in or through various water bodies. These natural bodies have an ecological process of their own and include lakes, ponds, seas, oceans, springs, streams and rivers. These are not mere receptacles or passages of water but also habitats for hundreds of living creatures: fish, insects, plants, snakes and reptiles. These water bodies also energise the water, just as they are energised by it. Water, as it rests in or passes through them, is oxygenated, cleaned and mineralised. If there are pollutants in the water, the ecological processes act to biodegrade them and to clean up the water again. Rocks and rapids in the streams and rivers help mix oxygen in the water, which the fish and other creatures living in the water then breathe for their survival.

When the water is polluted beyond its capacity to assimilate the pollutants, then these various functions of the aquatic and marine ecosystems get compromised. Similarly, if large quantities of water are extracted from such water bodies, then again the ecosystem gets affected and cannot perform normally. Where excessive pollution or extraction continues over time, the ecosystem gets irretrievably damaged, sometimes becoming incapable of supporting even the most basic life forms. Apart from the loss of fish and other life forms, this means that the water body is no longer able to cleanse the water and the water either becomes useless for human use. It has to be subjected to an expensive process of artificial cleansing before it can again be used.

Polluted water also poses a threat to its users. The threat to the environment has already been explained. It also threatens human health and it is estimated that 10,000 children die every day in India due to water related diseases. Also, water that contains large quantities of silt does damage to human made structures, silting up dams and tanks and damaging hydroelectric turbines.

Given the growing human population and the consequent increase in the demand for water, controlling the use and wastage of water, especially 'treated' water, is a high priority. What is required is 'demand side management' of water. The current patterns of water use are not only inequitable but also wasteful and unsustainable. While the well to do in a city throw away 12 to 16 litres of 'treated' water every time they flush their cistern, the poor in the same city have to line up for hours to get even one bucket of water. Our houses and industries are not designed to be water efficient and millions of litres of water are wasted because of leaking taps or outdated industrial processes.

12.3.5 Industry

Industrial growth is seen as central to economic development. However, in order for industry to be environmentally sustainable and for it to contribute to overall sustainable development, it must be environmentally friendly, or 'green', from 'cradle to grave'. This means that right from the setting up of the industry and the extraction of raw material and the generation of energy, through its production process and the nature of the produce, to the decommissioning of each plant and the final disposal of each product, the sector must be green.

If the Industrial sector is not environmentally friendly, it puts unsustainable pressures on the environment, both by using more natural resources than can be replaced and discharging more waste than can be assimilated. By using natural resources inefficiently and by polluting needlessly, an industry takes away the opportunity for additional production out of the same natural resources and the consequent additional discharge of pollutants. So, industries that are green not only negatively affect the environment but also take away the opportunity for additional industrial production.

In India, both water and electricity are subsidised, in the sense that their true cost, especially if you include the environmental costs, are not recovered from the consumers. Water and electricity are also two of the resources that are most often wastefully used. It is therefore imperative to conduct environmental audits of industries and of the industrial sector. To make such audits meaningful, standards must be prescribed for the quantity of water and electricity to be used in the production of various types of goods and the provision of various services.

It is preferable to prevent pollution, rather than to try and control it once it has happened. In order to prevent pollution, it is important that production technologies must also be green. The use of green technologies is not only good for the environment but also economically beneficial. Environment friendly technologies consume less water and electricity per unit of production and produce less waste. The costs of raw materials and of waste disposal are also, therefore, minimised, along with the expenditure on electricity and water. Besides, many green processes link up production processes in a way that the wastes of one process become the raw materials of another. Therefore, industries can be located and designed in ways such that the quantity of waste is minimised and the cost of purchasing raw materials is cut down

Another area of concern is that of packaging. Again, because garbage collection and disposal is done at public cost, not chargeable to the industry, many industries pack their products in an environmentally unfriendly manner. The use of plastics and other toxic or non-biodegradable materials as packaging material, needs to be controlled. The products themselves must be such that they or the materials they are made of, could be recycled once their life was over. This would not only save on raw materials but also lessen the problem of garbage control.

12.3.6 Energy

Power projects have historically had significant social and environmental costs associated with them. The two most common types of such projects in India are hydro and thermal power projects.

Hydroelectric projects: Hydroelectric projects, especially those involving large dams, usually have the more significant environmental and social impacts. Some of the main impacts are listed below:

Upstream of the dam

1) Degradation of the catchment. This can be due to the project, partly because of project activities and partly because of increased pressures on the remaining catchment, once a part has been submerged under the reservoir. Apart from the adverse impacts, this has on the biodiversity of the region, it also often has critical implications on the livelihood needs of the local people.

2) Of course, degraded catchments, whatever be the cause of degradation, can also have significant impacts on the dam project itself by, among other things

   - Increasing the silt load
   - Causing erratic water runoffs
   - Posing a possible threat of surplussing due to sudden increase in water flow

3) There is the threat of backwater build-ups and consequent floods and destruction

4) There is also the threat of reduced water availability upstream, as the water is required to fill the reservoir

At the reservoir and project site

5) Dust Pollution
6) The threat to rim stability
7) The potential for breeding vectors
8) Adverse impact on the aquatic ecosystem and biodiversity
9) Possible adverse Impact on fisheries
10) Impact on the water quality including potential for mineral contamination of water
11) Submergence and destruction of flora and fauna
12) Submergence of agricultural land
13) Submergence of grazing land
14) Submergence of sources of local fuel wood and other non timber forest produce
15) Reservoir induced seismicity
16) Adverse micro climatic changes
17) Human Displacement

Downstream

18) Adverse impacts on aquatic ecosystem and biodiversity downstream
19) Adverse impact on fisheries downstream
20) Adverse impact on water availability downstream
21) Adverse impact on water pollution levels downstream, especially due to reduced river flow
22) Possible salt water ingress
23) Threat from sudden releases of water
24) Threat from dam failure

Command Area (in multipurpose projects)

25) Threat of water logging and salinity
26) Threat of vector breeding

Unfortunately, there are many projects in India and in other parts of the world, which manifest one or more of these adverse impacts.

Hydroelectric projects in India are often not investigated properly for their environmental and social impacts. Their environmental and social viability is, therefore, not clearly established. Besides, the measures to mitigate the social and environmental impacts are often inadequate. Also, activities related to the assessment and mitigation of environmental and social costs are often started very late and then hurried along so as not to delay project implementation.

There has been an unfortunate tendency, in recent years, to grant hydroelectric projects "conditional clearance", with the stipulation that environmental assessment and the mitigation of adverse impacts be carried on pari passu. Some prominent beneficiaries of such clearances are the Sardar Sarovar Project in Gujarat, the Indira Sagar Narmada Project in Madhya Pradesh, and the Tehri Project in Uttar Pradesh.

What such conditional clearances imply is that the project is given a go ahead before its environmental impacts have been assessed and, consequently, its viability established. It also usually means that the assessment is never properly done and mitigative measures are delayed to a point where they become ineffective.

Rehabilitation: Hydroelectric projects also take a heavy toll of the human beings living in the submergence areas, who are made homeless in the thousands. Till recently, there were very inhumane rehabilitation policies, where, by and large, the "oustees" were handed a small amount of money in lieu of their homes, livelihood and heritage, and asked to fend for themselves. Recently, there has been a serious effort to change all this. Some of the newer projects, notably the Sardar Sarovar Project in Gujarat, offer land for land and other facilities to the "project affected people".

Despite this, the cost paid by the project affected people, mostly poor villagers and tribals, is horrific. The benefits of the electricity generated goes mostly to the rural rich and to the urban populations.

Coal Based Thermal Power Projects: Though the adverse environmental and social impacts of thermal power projects are not as dramatic as that of dams, they are still significant. This is especially so if one assesses the impacts from "cradle to grave", i.e., including the impact of mining the coal and of its transportation to the power plant.

The major environmental and social impacts of thermal power stations are listed below.

Construction phase

1) Displacement of people
2) Dust pollution
3) Local level disturbance
4) Destruction of fauna and flora

Operational phase

5) Air pollution
6) Water pollution
7) Withdrawal of water
8) Land pollution, mainly through fly ash
9) Noise pollution
10) Micro climatic changes

Unfortunately, thermal power plants are often not properly assessed for their environmental and social impacts, and alternative sites and technologies are rarely explored.

Many examples of thermal power plants, which were posed for environmental clearance without a proper appreciation of the environmental issues, are available. Some of the notable examples are described below.

The Dholpur Thermal Power Project, Rajasthan

This power project is to be located on the banks of the Chambal River, adjacent and, in part, within the National Chambal Sanctuary. The efforts of the Environmental Appraisal Committee to get the state government to shift this power station even a few kilometres, so that the impact on the sanctuary could be minimised, were unsuccessful. Consequently, the project was not accorded clearance for many years and has only recently managed to get cleared, in its initial location, but with very stringent environmental conditions. The loss of time and the additional costs of environmental safeguards could all have been prevented if the project had initially been shifted to a more suitable site.

Kayamkullam Power Project, Kerala

This project is to be located adjacent to a fragile system of Kayals (backwaters) in the state of Kerala. The project envisages dredging the Kayals in order to get earth fill material for the project site. Such dredging would destroy the kayal as an ecosystem and have significant adverse impact on the fisheries in the region. Again, efforts to have the site shifted by a few kilometres were not successful. The project was, therefore, not recommended for clearance. Later, the Ministry of Environment and Forests cleared the project, over ruling the recommendations of its own appraisal committee. However, if the project does come up it will have unacceptable environmental costs.

Perhaps the three most critical issues concerning thermal power stations, in terms of their social and environmental impacts are:

1) The location of the plant. Inappropriate locations imply heavy environmental and social costs and an inability to adequately mitigate these costs without making the project economically non-viable.
2) The use and discharge of water. As water is a scarce commodity in most parts of the country, the use of water by power stations results in greater, sometimes critical, deprivations for the local populations.
3) The dumping of fly ash. Fly ash is perhaps the single greatest hazard to the environment, to land and to human health.

12.3.7 Transport

The contribution to air pollution levels, especially urban air pollution levels, of the transport sector is significant. This is primarily because of the concentration of vehicles in urban areas, the technology prevalent, the poor state of maintenance of vehicles, the poor quality of fuel and, sometimes, local climatic conditions.

Air pollution levels in most of our cities are much above the prescribed limits, especially for suspended particulate matter (SPM). Some recent statistics are given below.

Average Annual SPM in ug/m3
WHO Recommended Standard 75 ug/m3

Agra	451.93	Patna	230.91
Mumbai	226.00	Pune	226.07
Delhi	543.00	Calcutta	394.00
Dhanbad	364.64	Surat	283.81
Ludhiana	380.17	Varanasi	489.23

Source: Reports of the National Environmental Engineering Research Institute and of the Central Pollution Control Board

In the last few years, the government has taken some important steps in tackling this problem. They have notified motor vehicle emission standards and introduced a system by which motor vehicles need to have pollution checks regularly. They have banned the sale of cars, which are not fitted with catalytic converters, in the metropolitan cities. They have introduced lead free petrol. Efforts are also on to improve the quality of fuel being supplied to upgrade motor vehicle technology, to ban the sale of loose oil at petrol pumps and to phase out of Delhi, for example, public vehicles which are over fifteen years old.

However, as long as the number of vehicles on the road keep increasing, the problem will only get worse. The only sustainable answer lies in improved public transport, which makes the use of private vehicles, or of individual public transport like taxis and three wheelers, less popular. Along with these, the other options like better and different fuels, and greener technologies, must be pursued.

For travel and transportation between towns and cities and across the country, some of the greenest options are no longer available. River transportation, if properly managed, can be a very environmentally friendly method of travel. Unfortunately, many of our rivers have now become too silted to be able to allow this option. However, if the earlier discussed methods of catchment area treatment and afforestation are implemented, then it might again become viable to desilt our rivers and other waterways and make them navigable for transporting people and goods.

Rail transport is also preferable to road transport. However, in the last few decades, there has been a much greater focus in developing the roadways sector rather than the railways. This strategy also needs to be reconsidered.

Check Your Progress 2

1) What is biodiversity?

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2) Discuss the basic issues regarding sustainable development in the area of water resources?

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3) Discuss the economic & social costs associated with hydroelectric power projects.?

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12.4 STRATEGIES FOR SUSTAINABLE DEVELOPMENT

The strategy for making the development process greener and environmentally sustainable involves ensuring that each sector and, within a sector, each project, scheme or activity, is environmentally friendly and contributes to a development process, which is sustainable.

There are various methods and instruments available to assess the environmental impact of such projects and activities and to ensure that they are environmentally viable. Two of these are environmental impact assessments and natural resource budgeting and accounting.

12.4.1 Environmental Impact Assessment (EIA)

Conducting an EIA of a project or an activity involves developing an environmental impact statement and then assessing the expected impacts of the project or activity.

An environmental impact statement (EIS) usually contains a list of the activities and processes that might have an adverse impact on the environment. These are then described in terms of the nature and severity of impact on the various elements of the environment. So, for example, an EIS of a proposed power station may look something like this:

ENVIRONMENTAL PARAMETERS

Activities	Air quality	Water availability	Water quality	Land	Soil	Ground water	Local inhabitants
Clearing of site	L	L	L	H	H	L	H
Land filling	L	L	M	H	H	L	M
Transportation of building materials	H						M
Construction of buildings	H			M	M		
Withdrawal of water		H	H			H	H
Discharge of water		M	H				H
Discharge of flyash	H	H	H	H	H	H	H
Discharge of SO2	H		M		M		H
Transportation of coal	H			H	H		H

H = high impact, M = medium, L = low, Blank = no impact

An assessment of the impacts, as laid out in the statement, is based on various factors. The purpose is to determine whether the proposed activity or project is environmentally viable and, as such, deserves environmental clearance. To decide this, various questions are considered. These include whether it is possible to prevent

or mitigate the anticipated adverse impacts? How severe are the final impacts? How valuable or unique is the affected ecosystem? And whether the benefits from the proposed activity or project justify such impacts?

12.4.2 Natural Resource Accounting and Budgeting

Till recently, environmental costs were rarely taken into consideration in the national planning exercises. This is because financial and economic experts do the planning and they do it in primarily a financial and economic context. However, natural resources are the most fundamental of human resources, certainly more fundamental than financial and economic resources.

Given the rapid environmental degradation, the world over, in the last few decades, many countries have begun to realise that unless environmental costs are incorporated into their national accounting system, a true picture of the health of their economy would not emerge. Perhaps motivated by this, the Government of India, in its policy statement on sustainable development, has undertaken to present before Parliament, each year, a natural resources budget.

Also, the Government of India has prepared a National Environmental Action Programme (NEAP) and is a party to Agenda 21. Both these documents further reiterate the commitment of the government to move towards a model of sustainable development.

In countries of the North, environmental economics is now a popular and fast growing discipline. Unfortunately, the models developed in these countries are not always appropriate to India. Despite this, there has been a concerted effort by various countries of the North and many international agencies to persuade India and other countries to accept their model of natural resources accounting.

The imperative for natural resource accounting seems, on the face of it, to flow from an urge to integrate natural resource parameters into the national accounting systems. This means that the GNP calculations of a country would reflect, each year, the use and accrual of natural resources. For specific projects and activities, a system of natural resource accounting would mean that the financial and economic costs of natural resources will be reflected in the cost benefit analysis carried out to assess the viability of the project.

Unfortunately, the methods currently being used by many countries of the North for generating natural resource accounts, have many problems. Some of them are outlined below:

Classification of Nature: The first problem relates to classification of nature into that which has economic value or, as economists sometimes describe it, has alternate uses, and that which has no economic value for it has no alternate use. The belief that some elements of nature have no alternate use and therefore no economic or financial value seems misplaced. Perhaps, if one takes a very narrow definition of "value" and "use", then one could argue this. However, it is well established that each individual living organism represents a unique element of biodiversity. Therefore, it is difficult to imagine even a single plant or creature that has no use.

Attaching Value: Even more difficult is the method by which economic and financial value is attached to elements of nature. Unfortunately, economics as a science can only put a replacement value to those goods and services, which are inputs into, or

outputs of, an economic process. Much of nature, critical as it is to human survival, is not an input or an output of an economic process. Therefore, for economists, it is either invaluable or valueless. As economics cannot handle the notion of invaluable, it tends to consider much of nature as valueless.

As an example, how can economics ascribe a realistic financial or economic value to the last surviving pair of a species of a bird, which currently might have no known economic function? Given the present methodology, such a pair would ordinarily be considered without economic value. Yet, this very species might, if it survives, become of very great economic value in the future. Nevertheless, as there is no way of predicting with any certainty whether this would happen or not, ascribing value becomes an impossible task.

The North-South Divide: Though the difficulties in ascribing economic value to elements of nature are common all over the world, their implications are far greater for countries of the South. Whereas in countries of the North most people have enough surpluses after meeting their immediate basic needs, to be willing to pay for recreation and long term needs like environmental conservation, this is not so in countries of the South. Therefore, if the economic value of the environment was to be determined through market forces, as is envisaged in many of the prevailing methodologies, it is unlikely that in countries like India the poor people would be in a position to choose long term needs over their immediate ones. Market forces would, consequently, make it difficult to conserve and protect anything.

Also, given the vast differences in the buying power of different segments of society in countries of the South, and between the North and the South, it is difficult to ensure socially just utilisation of natural resources. This is especially so if decisions were to be made solely or primarily on an economic basis.

Undervaluing Nature: There is also a tendency of governments, dominated by imperatives for economic growth, to systematically undervalue the contributions of natural ecosystems to the economy and to human welfare in general. For example, a forest can be contrasted with a human made industry. Whereas the human made industry requires inputs of capital, energy, raw materials, maintenance, replacement, and a labour force to make it productive, the forest, as an industry, produces goods and services critical to humanity without requiring any of these. It generates its own energy, produces its own raw materials, maintains and replaces itself, and goes on for eternity without needing any human input. However, the economic value attributed to forests never reflects this miracle of productivity and renewability.

The Solution: But what is the solution? Perhaps one way out is to adopt a dual approach of both budgeting and accounting. The elements of this approach are described below.

First, a natural resource, say water, needs to be budgeted in physical terms and allocations made to meet the basic ecological and social requirements. This means that, in a river, the minimum flows required for maintaining the ecological balance of the river and consequently its ability to cleanse itself and support life, must be assured.

Once this is done, then the surplus water must next be allocated for meeting the basic needs of the human populations dependent on the river. This includes their drinking water requirements and other basic needs. If any 'surplus' remains, this can then be subjected to market forces and its use determined based on the paying capacity of the various contenders.

In such a model, where there is industrial demand for water, then the industrial sector must pay for enhancing lean season flows by, for example, regenerating catchments, in order to produce larger surpluses. There is also, then, an economic incentive to invest in water saving technology, as the real cost of water is being charged.

Check Your Progress 3

1) What is Environment Impact Assessment?

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2) What are the methods of natural resources accounting and budgeting?

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12.5 LET US SUM UP

In this unit we started by discussing how the term 'development' was used over the years and how its meaning expanded from mere economic growth to growth with equity and, now, growth which is sustainable. We then went on to discuss the notion of 'carrying capacity'.

We discussed how every ecosystem has a limited capacity to produce and assimilate. When these limits are exceeded, the ecosystem degrades and becomes dysfunctional. A dysfunctional ecosystem cannot sustain its contribution and slowly dies.

We then went on to discuss how the carrying capacity of an ecosystem defines the limits within which the development process can be sustained.

Next, we looked at various sectors of the economy and discussed how each sector can be made more environmentally friendly, thereby contributing to sustainable development. We saw that making sectors environmentally friendly not only helped the environment but directly and indirectly boosted the economy.

Finally, we discussed two of the strategies that could be used to ensure that development activities, projects and policies were environmentally friendly and thereby supportive of sustainable development. The first of these strategies, conducting environmental impact assessments, involved assessing the impacts of activities, projects and policies on different elements of the environment. Based on such an assessment, a decision can be made about which of these are environmentally viable.

The developing of natural resource accounts and budgets is another strategy, which allows us to make sure that natural resources are optimally allocated and are sustainably used.

12.6 KEY WORDS

Acid Rain: Precipitation that has been polluted by acid.

Aquatic: Of water, living in or near water.

Aquifer: A natural underground or sub-surface water reservoir.

Biodegrade: To break down something into ingredients that can be assimilated by nature.

UNIT 12 ENVIRONMENTAL PROBLEMS AND POLICES IN INDIA

Structure

12.0 OBJECTIVES

After going through this unit you would be in a position to

- analyse the nature of environmental problems in India;
- appreciate the evolution of environmental policies over time in India;
- explain the various issues in the implementation and enforcement of environmental policies;
- explain the characteristics of modern approach of joint management of forests; and
- explain the concept of social forestry.

12.1 INTRODUCTION

Last two decades have witnessed dramatic rise in environmental concerns. Governments in various countries have enacted legislations to prevent pollution of natural resources such as air and water and to conserve and ensure sustainable use of forest resources. In India various Acts have been put in place to protect environmental resources. In the theoretical literature on environmental policies (see Unit 9), there is a choice among policy instruments ranging from command and control (CAC) type of instruments to market based instruments (MBI). Until the early-1970s most countries, including developed ones, relied heavily on CAC type of instruments. Since the 1970s many developed countries have been using MBIs for environmental conservation. There is also a perceptible difference even in the choice among MBIs. The United States, for example, preferred 'tradable emission permits' presumably because of its reliance on the allocative efficiency of markets while many countries in Europe seem to prefer fiscal approach to solve the pollution problem because of their commitment to the concept of welfare state.

12.2 NATURE OF ENVIRONMENTAL PROBLEMS IN INDIA

Broadly speaking environment is essential for continuation of life on earth. It performs several functions which can be divided into four categories. These are, i) production functions, ii) regulation functions, iii) habitat functions, and iv) information functions. These functions and their valuation methods are explained in Unit 8. As you are aware, environmental degradation restricts the flow of environmental services. Dumping of pollutants in excess of its assimilative capacity into air, water and soil results in deterioration of the quality of these vital resources.

The nature of environmental problem depends upon the level of economic development and the geographical condition of the area under consideration. India being a developing economy with a low per capita income, high population density, agriculture-dependent labour force, and high percentage of rural areas, the problems here are different from those in developed countries. The tropical climate with scanty rainfall in many areas also brings in a specific set of environmental problems. While acknowledging the fact that it is difficult to describe all the problems and analyse the underlying factors, some important problems are presented below.

Poverty, illiteracy and lack of awareness have aggravated environmental problems in many cases. Poverty in rural areas, largely due to unavailability of gainful employment, compels people to go to the nearby forests to collect fuelwood and minor forest products to supplement their household income. Agriculture being the backbone of the country and draught animal being the major source of power, animals are reared in large numbers and sent to forests for grazing. Cooking by using fuelwood not only aggravates destruction of forest but also releases harmful gases into the air. Lack of proper sanitation both in rural areas and urban slums vitiates the local environment. High population density in urban areas without adequate infrastructure such as water and electricity supply, public transport and waste disposal has brought in many environmental problems. For example, lack of public transport and rise in per capita income have led urban households to go for private vehicles which has increased fuel consumption, traffic congestion, and increased emission from vehicles. Tightening of emission standards and use of cleaner fuel have not been able to offset the pollution load.

Technological progress has also contributed to environmental problems in India.

Pollution abatement technology is available in many cases, but it is not adopted as it increases costs of production. The incentives offered through tax concessions and subsidies for installation of pollution abatement technology are not found to be adequate. Disposal of effluents without treatment have increased pollution of air, water and soil. Technological progress in agriculture has led to increased use of fertilizer on land which has increased pollution of land. The cultivation of water-intensive crops by using ground water has depleted ground water table. In order to attract investment several governments offer concessions to industries overlooking environmental concerns. In the process industries come up in the area but convert the state into a pollution heaven.

Certain legislations have been enacted, but enforcement of these laws has been poor. We discuss the policies enacted in India to conserve environmental resources and maintain ecological balance.

12.3 AN OVERVIEW OF ENVIRONMENTAL POLICIES IN INDIA

In India, legislations directly aimed at environmental protection were implemented for the first time in 1974 in the form of the Water (Prevention and Control of Pollution) Act. Prior to that, however, there were certain legislations enacted which have a bearing on environment indirectly (e.g., Motor Vehicles Act, Factories Act and Insecticides Act). After the Water Act, two notable laws have been introduced: First one is the 42nd Amendment of the Constitution in 1977 which has two sub divisions: (i) Entry 48A mentions that the state will protect and improve the environment and safeguard forests and wildlife; and (ii) Entry 51A suggests that it is also the duty of the citizens to protect and improve the natural environment including wildlife. The forty-second amendment was followed by the Forest Conservation Act, 1980; and subsequently the Air (Prevention and Control of Pollution) Act, 1981. A comprehensive legislation on environment covering all aspects was enacted in 1986 in the form of the Environment Protection Act, 1986.

Two international conferences on environment and development – one at Stockholm in 1972 and the other at Rio de Janeiro in 1992 – have influenced environmental policies in most countries, including India. Many countries and international agencies have accepted the 'polluter pays principle', the 'precautionary principle' and the concept of 'intergenerational equity' as guidelines for designing environmental policies.

The United Nations Conference on Environment and Development held at Rio in 1992 specifies the following objectives of environment policy:

(i) to incorporate environmental costs in the decisions of producers and consumers, and not to pass these costs on to the other parts of society, other countries or to future generations;

(ii) to move more fully towards the integration of social and environmental costs into economic activities, so that prices will appropriately reflect the relative scarcity and total value of resources and contribute towards the prevention of environmental degradation; and

(iii) to include, wherever appropriate, market principles in the framing of economic instruments and policies to pursue sustainable development.

Check Your Progress 1

1. Explain the nature of environmental problems in India.

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2. Mention the specific points of 'market-based principles' of environmental policy stated in the UN conference at Rio, 1992.

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12.4 STATUS OF ENVIRONMENTAL LEGISLATIONS IN INDIA

In the previous Section we discussed about the evolution of environmental policy in India. In this Section we present the status of environmental legislation in India. The material presented here is generously drawn from Sankar (1998).

12.4.1 Provision in the Constitution

The Indian Constitution provides for a federal structure within the framework of parliamentary form of government. Part XI of the Constitution governs the division of legislative and administrative authority between the centre and the states. Subject areas for legislation have been divided into three lists, viz., Union List, State List and Concurrent List.

Article 253 empowers the Parliament 'to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body'. Provisions in the Constitution of India envisage a significant role for the central government on matters relating to environmental protection.

Even though location-specific subjects generally come under the jurisdiction of local bodies (municipalities and panchayats) until 1992, they were not given the necessary power to deal with these subjects. It is stated that 'the state shall take steps to organize village panchayats and endow them with such power and authority as may be necessary to enable them to function as units of self government'.

12.4.2 The Wild Life (Protection) Act, 1972

This Act was enacted under the provisions of Article 252 to prevent the decline of

wild animals and birds. It prohibits poaching of certain animals except for the purpose of education or scientific research. In respect of certain wild animals, license is a prerequisite for their hunting. State government may declare any area as a sanctuary or national park if it considers that such area is of adequate ecological, faunal, floral, geomorphological, natural or zoological significance for protecting, propagating or developing wild life or its environment.

12.4.3 The Water (Prevention and Control of Pollution) Act, 1974

As mentioned earlier, the water Act was put in place in 1974. For the purpose of implementation of the Water Act, the Central Pollution Control Board (CPCB) and State Pollution Control Boards (SPCB) were established. The following are the specific features of the Act.

- Failure to comply with the regulations of the Board is punishable by imprisonment up to 3 months and/or a fine of up to Rs.10000.
- Non-compliance in certain cases will force the polluting units to shut down the activity.

The 1988 amendment to the Act necessitates that there should be no new discharge of trade effluent or sewage without permission of the State Boards. The penalty for non-compliance ranges from one and a half years to six years imprisonment and a fine. Tampering with or damaging the devices put up by the Pollution Control Board are punishable by imprisonment and a fine up to Rs. 10,000.

12.4.4 The Air (Prevention and Control of Pollution) Act, 1981

The Central and State Pollution Control Boards were empowered to prevent and control air pollution. The specific features are:

- The Central Board will advise the Government on matters regarding air pollution, coordinate activities of the State Boards, specify desirable air quality standards, train persons engaged in controlling air pollution, disseminate information, etc. The Board appoints analysts for testing samples of air for the purpose of implementing the Act.
- The state governments are empowered by the Act to declare any area within the state an air pollution control area after consulting the State Boards. In such areas regulators can prohibit the use of certain fuels, materials or appliances which may cause air pollution.
- In discharging its duties the Board may issue directions comprising closure, prohibition or regulation of any industry, operation or process; stopping or control of water or power supply and other services.
- Failure to comply with the Act is punishable with imprisonment ranging from one and a half years to six years with a fine.

The Water and Air Acts empower the Boards to lay down ambient air and water quality standards. The actual provisions for imposing penalty and imprisonment, however, are confined to source specific standards for individual polluting units.

12.4.5 The Tiwari Committee, 1980

The Government of India set up a committee in January 1980, under the chairmanship of N.D. Tiwari, then Deputy Chairman of the Planning Commission,

to review the existing environmental legislation and to recommend legislative measures and administrative machinery for environmental protection.

The central government established the Department of Environment in 1980, which was transferred to the newly created Ministry of Environment & Forests (MoEF) in 1985. It also set up the Land Commission. Environmental Impact Assessment (EIA) has become mandatory for highly polluting industries since 1994.

12.4.6 Constitutional Amendments and Public Interest Litigation

The 73rd and 74th Constitutional Amendments of 1992 recognized the three-tier structure of the government by devolution of power to the local bodies, viz., panchayats in rural areas and municipalities in urban areas. The Eleventh Schedule of the Indian Constitution lists environmental activities such as soil conservation, water management, social forestry and non-conventional energy that panchayats can undertake. The Twelfth Schedule lists activities such as water supply, public health and sanitation, solid waste management and environmental protection, which the municipalities can undertake. These grassroot level institutions can facilitate greater participation by the people in local affairs, promote better planning and implementation of developmental and environmental programmes and be more responsive to the needs of people.

12.4.7 The Environment (Protection) Act, 1986

This Act was enacted following the Bhopal gas tragedy in 1984 which claimed more than 3000 lives. The Act refers to the decisions taken at the Stockholm Conference and expresses concern about the decline in environmental quality, increasing pollution, loss of vegetational cover and biological diversity, excessive concentration of harmful chemicals in the ambient atmosphere, growing risks of environmental accidents, and threats to life system.

According to this Act the environment includes 'water, air and land, and the interrelationship which exists between water, air and land, and human beings, other living creatures, plants, micro-organism and property'. It defines hazardous substance as 'any substance or preparation which, by reasons of its chemical or physiochemical properties or handling, is liable to cause harm to human beings, other living creatures, plants, micro-organism, property or the environment'.

This Act gives the following powers to the central government:

a) coordination of actions of the state governments, officers and other authorities under the Act;

b) planning and execution of a nation-wide programme for the prevention, control and abatement of environmental pollution;

c) laying down standards for the quality of environment in its various aspects;

d) laying down standards for emission or discharge of environmental pollutants from various sources;

e) laying down procedures and safeguards for the prevention of accidents which may cause environmental pollution and remedial measures for such accidents;

f) examination of such manufacturing processes, materials and substances as are likely to cause environmental pollution;

g) carrying out and sponsoring investigations and research relating to problems of environmental pollution;

h) inspection of any premises, plant, equipment, machinery, manufacturing or other processes, materials or substances for the prevention, control and abatement of environmental pollution;

i) establishment or recognition of environmental laboratories and institutions;

j) collection and dissemination of information in respect of matters relating to environmental pollution; and

k) preparation of manuals, codes or guides relating to the prevention, control and abatement of environmental pollution.

It empowers the central government to constitute an authority for the purpose of exercising such powers and functions under this Act. The central government may set rules covering the following matters:

a) standards of quality of air, water or soil for various areas and purposes;

b) maximum allowable limits of concentration of various environmental pollutants (including noise) for different areas;

c) procedures and safeguards for the handling of hazardous substances;

d) prohibitions and restrictions on the handling of hazardous substances in different areas; and

e) prohibitions and restrictions on the location of industries and the carrying on the process and operation in different areas; and

f) procedures and safeguards for the prevention of accidents, which may cause environmental pollution and for providing for remedial measures for such accidents.

The Environment (Protection) Act is a comprehensive piece of legislation. Under this Act, environment protection rules were announced in 1986. Schedule VI under this rule contains specification of standards of different types. Some of the rules framed by using the powers given under the Environment Act are: i) Hazardous Wastes (Management and Handling) Rules 1989; ii) Manufacture, Storage, and Import of Hazardous Chemicals Rules, 1989; iii) Chemical Accident (Emergency Planning, Preparedness and Response) Rules, 1996; and iv) Bio-medical Waste (Management and Handling) Rules, 1998. Under Rule 14 of the Environment Protection Rules 1986, the government evolved guidelines for submission of yearly environmental audit/statement by units requiring consent under the Water Act, Air Act and authorization under Hazardous Wastes (Management and Handling) Rules. However, submission of an environmental statement by polluting units seeking consent under the Water Act, 1974 or the Air Act, 1981 or both and authorization under the Hazardous Wastes Rules, 1989 to the concerned State Pollution Control Board (SPCB) was made mandatory only in 1992.

12.4.8 Policy Statement for Abatement of Pollution, 1992

The Policy Statement for Abatement of Pollution issued by the Ministry of Environment and Forests (MoEF) in February 1992 identifies the environment problems and admits that 'the state of the environment continues to deteriorate'. It favours a mix of instruments in the form of legislation and regulation, fiscal incentives, voluntary agreements, educational programmes and information

campaigns. It recommends the polluter pays principle in order to give industries and consumers clear signals about the cost of using environmental and natural resources.

12.4.9 Fiscal Incentives

There are a few economic instruments in vogue for the polluters in India in the form of fiscal incentives. These are mainly tax exemptions or subsidies which keep on changing as per policy guidelines of the government. We mention some of the provisions available in 2006 below.

- Depreciation allowance at the rate of 100 per cent for installing pollution control devices.
- Concessions in customs duty on imported equipment and spares for pollution control.
- Excise duty at the reduced rate on manufactured goods that are used for pollution control.
- Excise duty exemption for bricks and blocks manufactured from fly ash and phospho-gypsum.
- Financial assistance towards capital investment up to 25 per cent or Rs. 50 lakh, whichever is less, is given as subsidy to industrialists from the small scale sector for setting up common effluent treatment facilities.
- Provision of loans at reduced rates of interest by financial institutions for installing pollution control devices.

Moreover, exemption on income tax is given for incurring expenditure by way of payments on any sum towards association or institutions which carry out programmes for conservation of natural resources.

12.5 IMPLEMENTATION OF LAWS RELATING TO ENVIRONMENTAL PROTECTION

The nodal agency for implementing various legislations relating to environmental protection at the centre is the Ministry of Environment and Forest (MoEF). Besides giving directions to the CPCB on matters relating to prevention and control of pollution, the MoEF is responsible for designing and implementing a wide range of programmes relating to environmental protection. The focus of various programmes of the Ministry and its associated organisations is on issues such as i) promotion of clean and low-waste technologies, ii) waste minimization, ii) reuse or recycling, iii) improvement of water quality, iv) environmental audit, v) natural resource accounting, vi) development of mass-based standards, and vii) institutional and human resource development. Based on the environmental laws and the directions given by the Supreme Court, the central government has created a number of authorities for designing, implementing and monitoring its environmental programmes. At the state level, most states have set up Departments of Environments and the SPCBs. The Supreme Court and the High Courts have played an active role in the enforcement of constitutional provisions and legislations relating to environmental protection.

The CPCB and the SPCBs are responsible for implementation of legislations relating to prevention and control of pollution. Pollution arises both from point sources (for

example, factories) and non-point sources (for example, automobiles). Source-specific effluent and emission standards have been fixed for polluting point sources. For non-point sources, as monitoring of pollution generation is very difficult, indirect measures of pollution prevention/control such as emission standards for automobile engines/new cars, lead-free petrol, fuel with low sulfur content, periodic inspection of vehicles, etc. are being adopted. In addition, ambient standards for air and water have been laid down and are being regularly monitored by the CPCB with the support of the SPCBs.

Despite the legislative and administrative efforts and fiscal incentives for pollution control, air and water pollution levels have exceeded ambient standards resulting in distinct deterioration, in air and water quality. The reason could be that, though standards have been laid down for ambient air and water quality, actual enforcement relates mostly to source specific standards laid down for individual polluters, factories, transport vehicles and so on. Furthermore, the ambient and source specific standards are laid down independently, unrelated in terms of the volume of pollution generating activities. Hence, it is quite possible that the quality of the environment could continue to deteriorate despite the high degree of compliance among individual polluters. It is also true that the degree of compliance itself is poor, adding to the adverse affects.

In enforcing the effluent standards, the SPCBs should follow guidelines such as treatment of the wastewater with the best available technology, minimisation of the discharge of wastes into the environment by recycling and reuse of waste materials as far as practicable. The state governments and the SPCBs can prescribe tighter standards taking into consideration the 'assimilative capacity' of the local environment. The central government can prohibit/restrict operations of industries in certain areas.

We have noted that the CPCB and the SPCBs have powers of examination of such manufacturing processes, materials and substances as are likely to cause environmental pollution. The polluting industries coming under the Water Act, Air Act and Environment Protection Act are required to get consent certificates from their respective SPCBs for starting an industry or continuation of production. They are also required to submit environmental audit statements in prescribed format to their SPCBs annually.

In India, the standards are determined mainly on the basis of comprehensive industry studies undertaken by technical institutions at the initiative of the CPCB. These studies provide estimates of pollution generation industry-wise, assess available abatement technologies and give tentative estimates of costs of abatement for different levels of abatement. The polluting units, however, complain that they are not given an opportunity to express their views on this matter. According to them:

(i) The standards laid down by Pollution Control Boards have been borrowed from developed western countries without assessing their relevance to Indian conditions. Hence, they argue that the standards are too stringent.

(ii) The standards for certain parameters have been fixed without considering the availability of least-cost abating technologies. National Environmental Engineering Research Institutes (NEERI) have been assigned the task of studying the feasibility of achieving the standards.

Another issue at the implementation level is whether or not a nationwide uniform effluent or emission standard is relevant. Critics of nationwide uniform standards

point out that the 'carrying capacities' of different regions differ and the trade-off between environmental quality and other goals such as growth and employment also differ across regions. As mentioned earlier, the Air Act and the Environment Protection Act empower the central and state governments to restrict or prohibit certain activities in specific areas on the basis of certain considerations. But the rules do not permit any state government or SPCB to lower the standards fixed by the central government in any region. On the other hand, there is a case for uniform standards throughout the country because in the absence of such standards, state governments may lower the standards in order to attract new industries.

The standards prescribed for most industries are concentration-based. In the case of effluents, a polluting unit can meet the standards by dilution of effluents by adding water. With growth of industries the aggregate amount of pollution can increase even when there is compliance at the plant level.

Enforcement of Standards

When the standards are the same for many industries or even when industry-specific standards are applied to all firms in the same industry, the aggregate costs of compliance with the standards will not be minimized. The reason is that the 'marginal abatement costs' even for firms within an industry vary from firm to firm because of variations in factors such as vintage of the firm, technology used, quality of input used, product mix, and size of the firm. When a regulatory agency puts restrictions on the process used or prescribes input-output norms or imposes other physical standards, the firms' choices in the minimization of abatement costs are constrained.

Effective enforcement of the standards involves costs to the SPCBs. In the absence of measurement tools installed at the firm, which can record the quantities of and concentrations of pollutants in the effluents, the SPCBs can monitor the firms' behaviour only by inspection and sampling. The Acts provide powers to the SPCBs to inspect the premises of the polluters and take samples in the manner prescribed. Recognized laboratories must test the water quality and report the results. When the concentrations of pollutants exceed the permissible levels, the SPCBs can issue show cause notice. The polluting units are given an opportunity to go to the Appellate Court. Meanwhile, the state governments can also intervene and influence the decisions of the SPCBs. Even though the SPCBs are autonomous bodies, the members owe their positions to the state governments and the Boards depend on the state governments for financial support. Many state governments are under pressure to delay or stop proceedings against the erring units because of the fear of loss of output or/and employment.

Poor enforcement of the laws occurs due to the following reasons. First, the control authorities do not have reliable information regarding the quantities of effluents/ emissions/solid wastes and their characteristics. There is *information asymmetry*: the polluters know more about the sources, magnitudes and concentrations of pollutants as well as the costs of controlling pollution than the regulators. It is very difficult on the part of the regulatory agencies to acquire and process the information from thousands of units dispersed in their regions. Second, the regulators face budget constraints. Most SPCBs do not have adequate technical facilities and skilled manpower for monitoring the polluting units and filing charges against the units violating the standards. Third, the fines are fixed in nominal terms and are independent of the extent of violations. Penalties such as imprisonment of officials, stoppage of water and electricity connections, and closure of units can impose

hardships on the affected firms, but in a weak enforcement regime with 'principal agent problem' collusion between regulators and regulated units are possible. Dispute settlement by going to the courts is a cumbersome process and involves considerable delays. This situation creates an opportunity to indulge in rent-seeking activities.

Until recently, the CPCB and the SPCBs concentrated their efforts on enforcing compliance with the standards by large and medium size units. They have classified the units under three categories – Red, Orange and Green, in terms of their pollution intensities. First of all, expected penalty for non-compliance higher than the cost of compliance is necessary to ensure compliance. Random checks are needed to ensure compliance.

It is suggested that alternative means such as adverse publicity for non-compliance by units, higher probability of inspection or/and sampling of units with poor compliance records, or/and seeking the assistance of NGOs and other local residents in detecting the violations should be experimented with.

In February 1991, the MoEF launched a scheme of labelling of environment-friendly products with ECOMARK. Under this scheme, any product which is made, used or disposed of in a way that significantly reduces the harm it would otherwise cause to the environment, would be considered as environment-friendly product. Many large industrial units, which are desirous of exporting their products are obtaining ISO 9001 certificates to get market access to the European Union, USA and other countries.

The judiciary has played a very active role in the enforcement of legislations and rules relating to environmental protection. In compliance with the various Supreme Court Orders, the MoEF has constituted several authorities under the Environment (Protection) Act, 1986. It is obvious that the Court has taken quasi-legislative and quasi-administrative functions. While the judgments have been helpful in pressurizing the errant polluting units to comply with the legislations, in reminding the responsibilities of the enforcing agencies and also in awakening public awareness of the environmental problems, there still remain some issues to be resolved. First, the existing information base and the capacity of the regulatory agencies for monitoring and enforcing the regulations are weak. Second, the judicial process is time-consuming.

Check Your Progress 2

1. What are the salient features of the Environment Protection Act, 1986?

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2. What are the specific issues arising from the implementation of the environmental laws?

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12.6 FOREST POLICY

Keeping the importance of forests in view a separate set of rules has been in place for the forest sector through various legislations.

12.6.1 A Brief History

During the Colonial era, Indian Forests Act was passed in 1865. Subsequently, the Forest Act, 1878 came into being as a comprehensive policy document. It provided for three classes of forests — reserved forests, protected forests, and village forests. The Madras presidency enacted the first wildlife statute for protection of wild elephants in 1873 and the Wild Birds Protection Act in 1887 to prohibit the possession or sale of wild birds. In 1912, the Central Government enacted a broader Wild Birds and Animals Protection Act, which specified closed hunting seasons and regulated the hunting of designated species through licensing. The Indian Forest Act, 1927 evolved during the pre-independence era, which consolidated the provisions of the Indian Forest Act of 1878 and amendments in between. The 1927 Act dealt with an additional category, namely non-government (private) forests, along with the three listed in the 1878 Act. Thus it specified four categories of forests, viz., reserved forests, village forests, protected forests, and non-government (private) forests. Any unauthorized felling of trees, quarrying, grazing and hunting in reserved forests is punishable with a fine or imprisonment.

After the independence, the Wildlife Act, 1972 and various Acts pertaining to Forest conservation and entitlement of tribals in the forest lands have been implemented.

12.6.2 Forest Management and Evolution of Forest Policies

The management of a forestland depends on many factors. The objectives may differ depending upon the following factors: (a) the type of the forest, (b) the nature of the ownership of forestland, (c) the socioeconomic and political conditions, and (d) the nature of the forest produce expected from the forest land. Forest can be managed either exclusively for extraction of timber or for both timber and non-timber forest products and services.

During the early nineteenth century, the extraction of timber was considered as primary function of forestry. Forest was exploited mainly for timber that had a strategic use for defense. The dawn of scientific forestry in India occurred when Dr. Dietrich Brandis was appointed as the first Inspector General of Forests in India. It was in this period, that forestry was organized on commercial lines with sustained yield principle of management. For the first time, 'Forest Working Plan' was introduced for managing forests in India. Working plan, which was a major tool of management, was a written document dealing with technical and economic aspects of forest management and development. It was a medium term plan for 10 to 15 years and covered the entire forests in a Forest Division, which is the unit of administration. Forest was managed on the basis of Forest Working Plan which prescribed the minimum girth limit for marking a tree for felling (cutting), the number of trees that can be felled per hectare, etc. The management of forests in

this manner continued till the Second World War, after which in order to meet the high demand for timber and other forest products, the working plan regulations were neglected and sustained yield principle could not be fulfilled. Over-exploitation of timber and poor regeneration finally resulted in loss of forest area both in public and private ownership/control.

The first National Forest Policy after independence was formulated in 1952. This policy laid more emphasis on the role of wood-based industries and this resulted in growth of more wood-based industries. To meet the high demand from industries, more programmes were started to expand plantation. To meet the committed supply, more natural forest cover got cleared for raising softwood plantations such as eucalyptus. While teak plantations were promoted during the early twentieth century, soft wood plantations and other industrial plantations were promoted especially after the National Forest Policy of 1952.

After 1980, timber harvesting has been restricted and various measures have also been taken to conserve bio-diversity. The importance given to conservation can be seen from the increase in the extent of protected area network. The number and area under wild life sanctuaries and national parks have increased after 1980. Nearly 50% of the wild life sanctuaries were notified in the 1980s. Due to policy initiatives taken both at national and state levels, forest has been considered not as a source of timber alone but also as a provider of non-timber forest products such as medicinal plants, honey, spices, resins, seeds and nuts, and forest services such as wilderness, eco-tourism and other conservation values. Non-wood forest products have been considered as a major source of livelihood to local tribal communities and therefore their management in a sustainable way needs special attention.

Keeping in view the need of the time the government enacted the National Forest Policy of 1988, which is a radical departure from the National Forest Policy of 1952. In the 1988 policy more emphasis is given on environmental stability and ecological balance. According to the National Forest Policy, 1988, 'the principal aim of forest policy must be to ensure environmental stability and maintenance of ecological balance'. The policy puts emphasis on control of soil erosion and denudation in the catchments of rivers, lakes and water reservoirs so that soil and water can be conserved. It will also help in mitigating floods and droughts, and retard siltation of reservoirs. The policy aims at increase in forest cover in the country through massive afforestation and social forestry programmes and increase productivity of forests to meet essential national needs. As per this policy the forest should not be seen as a mere source of revenue. In order to learn more about the changing nature of forestry in India you are suggested to go through Unit 7, Block 2 of the BA level course EEC-14: Agricultural Development in India.

12.7 ALTERNATIVE INSTITUTIONAL MECHANISMS

In this Section we highlight various alternative approaches to forest management prevalent in India.

12.7.1 Joint Forest and Joint Protected Area Management

It has been increasingly recognized that the success of any effort to protect natural resources, needs cooperation of people living in and around forest ecosystems. The IUCN Inter Commission Task Force on Local Communities and Protected Areas (TFLCPA), which was set up in 1999 by World Commission on Protected Areas (WCPA) and the Commission on Environmental, Economic and Social Policy

(CEESP) recognize the importance of using the traditional knowledge of the local communities in conserving the resources and its management in a sustainable manner. The Vision Statement of the Task Force includes the following points:

- The local community's own ways of valuing biodiversity need to be respected and utilized in conservation measures.
- The tenurial security of local communities over land and other resources is essential in creating and maintaining a stake in natural resource and biodiversity conservation.
- Community-based institutions must be encouraged.

The Task Force further lists down the rights and responsibilities of local communities in relation to the protected areas.

The National Forest Policy of India, 1988 declared that local communities were to be involved in natural resource conservation. The Joint Forest Management (JFM) approach initiated in India during the 1990s seeks to develop partnerships between state forest departments (as owners) and local community (as co-managers) for sustainable forest management. JFM has been viewed by some observers as a move towards a democratic decentralization of forest management in India. Building on the JFM programme, there is the possibility of Joint Protected Area Management (JPAM). One such initiative is the Integrated Conservation and Development Projects (ICDPs) or 'Eco-development' approach, which tries to link protected area management with local social and economic development, usually by providing incentives to support conservation and sustainable use of natural resources. However, it has many weaknesses. One important issue is that protected area management that meets dual objective of conservation and development will face difficulty unless means are found to channel the return from protection to those on whom the burden of protection falls. Usually poor sections of the community, particularly those who rely on the forest for subsistence use are often the ones who lose.

In 1991, the Government of India initiated eco-development for 'protected area' (PA) management in some selected national parks and wildlife sanctuaries. It tried to integrate conservation of biodiversity through local economic development. The eco-development programmes, which are being implemented have the following objectives:

(a) improve the capacity of protected area managers to conserve biodiversity and increase opportunities for local participation in PA management activities and decisions;

(b) reduce negative impacts of local people on biodiversity and of protected areas on local people and increase collaboration of local people in conservation efforts;

(c) develop more effective and extensive support for eco-development of PAs;

(d) ensure effective management of this project ;and

(e) prepare future biodiversity projects.

All the eco-development activities are administered by village eco-development committees (VECs) or forest protection committees (FPCs). The aim is to reduce forest dependence and to compensate local communities — in cash and kind as

well as through alternative off-farm income generating opportunities — for the lost access to resources in the protected areas. In short, it emphasizes peoples' participation in natural resource management through empowerment. However, it has been pointed out by some researchers that under the present tenure arrangements, it has been difficult to involve local people in conservation since the earlier exclusionary approach failed to develop mechanism for people's involvement and hence lack of interest in conservation among local communities. While under JFM villagers are able to obtain a share of forest produce, wildlife laws prohibit the extraction of forest produce, except some listed products, for human use from national parks and wildlife sanctuaries.

12.7.2 Social Forestry

The concept of social forestry began in India with the interim recommendations of the National Commission on Agriculture in 1976. Increasing pressures from human population has resulted in severe depletion of much of the natural forests. Social forestry aims at promoting growing of trees on lands accessible to village people in order to reduce the pressures on natural forest. Agro-forestry is an integral part of social forestry and hence social forestry also covers production of food crops, fodder crops, legumes, tubers, etc. Social forestry can be thought of as the science and art of growing trees and other vegetation on all land available for the purpose — mainly outside the traditional forest areas with the involvement of forest community resulting in a balanced land use. Also it is envisaged that it will provide a wide range of services to the individual and society. Social forestry helps in achieving ecological balance and control soil erosion. It helps alleviating rural poverty by providing them with different avenues of income earning opportunities. It aims at promoting the socio-economic conditions of society as a whole by augmenting the production of small timber, fuelwood, fodder, fruits, fibers, cereals, tubers, oilseeds, etc. It is a labour-intensive scheme and potentially generates huge employment. Social forestry programmes in many states, however, are facing acute shortage of land.

Check Your Progress 3

1. What are the benefits of Joint Forest Management as compared to the public management of forests?

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2. Explain the concept of social forestry and its relevance.

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UNIT 7 ECONOMIC REFORMS IN INDIA

Structure

7.0 OBJECTIVES

The unit introduces to you the need for change of basic policies for economic reforms after four decades of development planning in which the public sector was considered as the principal engine of development. After going through this unit, you will be able to:

- know the basic rationale behind economic reforms introduced in 1991;
- state the three basic elements of economic reforms, viz., liberalisation, privatisation and globalisation;
- explain the policy changes introduced to promote liberalisation, privatisation and globalisation;
- appreciate the need for redefining the role of the public sector; and
- identify the impediments in the implementation of economic reforms.

7.1 INTRODUCTION

The Indian economy is passing through a process of transition from a highly regulated economy in which a number of sanctions had to be acquired before starting a unit of production in any industry. Sometimes, it took over three years to obtain all the sanctions from different authorities of the government before an entrepreneur could start production. This led to widespread corruption in which the principal beneficiary was the bureaucracy engaged in the grant of sanctions. This resulted in enormous corruption and government officials in collusion with political bosses earned fabulous sums as hush money via corruption. It was strongly felt that the system of licenses and controls should be dismantled so that businessmen desirous of undertaking investment could achieve their objective of industrial growth without unnecessary hurdles.

Secondly, during the first four decades of development planning, the country relied heavily on the public sector which was considered as the engine of development. There is no doubt that the public sector did play very crucial role in setting up industrial units in heavy and basic industries, in infrastructure development – both economic and social. But at that time, the private sector neither possessed the resources to undertake lumpy investment, nor did it have the necessary competence and expertise. But over a period of four decades, the private sector did acquire sufficient resources to undertake heavy investment and also wanted to enter areas hitherto reserved for the public sector. There was disenchantment with the functioning of the public sector which was plagued by inefficiencies and high cost of operation. Quite a large number of public enterprises were running in losses continuously for several years. The losses had to be made good by the Government out of the receipts of taxes from the people. This required a rethinking because government could not be expected to meet the losses of these enterprises year after year. Although there was a need to bring about basic change in the structure of the economy, the Government was not gathering enough courage to introduce a fundamental change. The first clear pronouncement on the public sector was made by the Government in 1984 when it was stated the public sector has spread into "too many areas where it should not be. We will be developing our public sector to undertake jobs that the private sector cannot do. But we will be opening up more to the private sector so that it can expand and the economy can grow more freely". Consequently, it opened the debate for redefining the role of the public sector. In other words, restricting the role of the public sector and enlarging the area of privatisation became the new 'mantra' of economic reform.

Thirdly, soon after independence, to help the growth of industry, the infant industry argument was used to protect Indian industry in hitherto unknown and newly emerging areas by using various trade barriers. This resulted in the growth of sheltered markets for Indian businessmen. As a consequence, Indian industry developed the mindset, 'once an infant, always an infant'. So every time, the Government thought of reducing trade barriers, the damage to national industrial interests argument was used to stall them. It was in 1991 that the Government under pressure from World Bank/IMF was forced to reduce trade barriers. It was argued under WTO pressure that all quantitative restrictions on all import items will be withdrawn by April 2001. The aim was to expose Indian industry to face world competition. The principal aim of economic reforms was to enter an era of globalisation which meant (a) free flow of goods and services, (b) free flow of technology, (c) free flow of capital, and (d) free movement of human beings, especially labour from one country to another. Economic reforms, therefore, require integrating the Indian economy with world economy. Thus, instead of depending on *import-substitution strategy* of growth, the emphasis in economic reforms was shifted to *export-led growth strategy.*

To sum up, economic reforms constitute three fundamental policy changes. They are: liberalisation, privatisation and globalisation. In short, this is known as LPG model of development.

7.2 RATIONALE OF ECONOMIC REFORMS

The rationale of economic reforms was provided by the Industrial Policy announced by the Government in 1991. The major objectives of the industrial policy were stated as under:

i) to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic controls;

ii) to introduce liberalisation with a view to integrate the Indian economy with the world economy;

iii) to remove restrictions on direct foreign investment as also to free the domestic entrepreneur from the restrictions of Monopolies and Restrictive Trade Practices (MRTP) Act; and

iv) to shed the load of public sector enterprises which have shown a very low rate of return or which were incurring losses over the years.

7.2.1 Liberalisation of the Economy

Removal of Industrial Licensing: All industrial licensing was abolished but for a shortlist of 18 industries related to security and strategic concerns, social reasons, hazardous chemicals and over-riding environmental reasons and items of elitist consumption industries reserved for the small scale sector which were to continue under the reservation list. Subsequently, all industries except for a small group of five industries, industrial licensing requirements have been done away with.

Dereservation of SSI Items: Although initially the Government decided to continue reservation of items under the SSI sector, but later, it gradually withdrew reservation in several SSI items every year. For instance, in 2003-04 budget, the Union Finance Minister announced dereservation of 75 items of laboratory chemicals, leather and leather products, plastic products, chemicals and chemical products and paper products. During 2005-06 budget, the Finance Minister announced dereservation of 108 items from the SSI list, out which 30 items belonged to the category of "textile products, including hosiery". Earlier the Government had announced dereservation of ready-made garments. In other words, even the small-scale industry (SSI) has been forced to face both domestic and international competition.

Withdrawing MRTP Restrictions: The restriction on the scrutiny of an investment proposal that it does not violate the provisions of MRTP Act was withdrawn. This freed big business houses to undertake expansion and establishment of new undertakings as well as to undertake mergers, amalgamations and takeovers, they were also freed in the appointment of directors. The thrust of policy in future, it was stated, would be more on controlling unfair or restrictive business practices. All this provided a more liberal environment for expansion of existing undertakings and setting up of new undertakings.

7.2.2 Privatisation of the Economy

Privatisation has to be viewed in two ways: In a narrow sense, it implies the induction of private ownership in a public sector undertaking. In a broader sense, it implies the enlargement of the scope of the private sector in the growth of the economy. In the initial phase of development planning in India, more especially after the Industrial Policy of 1956, the socialisation of the economy was measured by the size of the public sector in the national economy. The greater the share of the public sector, the greater was the degree of socialisation of the economy. Under economic reforms after 1991, the main thrust is that the private sector is

considered as the engine of growth. By placing restrictions on the public sector and by reducing its role in several areas where it earlier enjoyed a monopolistic position, the new environment assigned an increasing role for the private sector. Over the years, this was bound to increase the share of the private sector in the economy. This is the meaning of privatisation in a broader sense. It is now accepted by one and all that economic reforms are intended to increase the role of the private sector in the process of development and the scope of the public sector will be narrowed down to providing infrastructure like roads, railways, electricity as also in providing social infrastructure in health and education. Even in economic and social infrastructure, the assistance of the private sector will be sought, but major responsibility will be that of the public sector.

Privatisation in the narrow sense can take several forms:

a) **Total Denationalisation:** This implies complete transfer of ownership of a public enterprise to private hands. Some examples of total denationalisation are: Allwyn Nissan – a public sector concern of Andhra Pradesh was handed over to Mahindra; Mangalore Chemical and Fertilisers – a public sector undertaking of Karnataka was handed over to UB Group and Maharashtra scooters was handed over to Bajaj Auto (India).

b) **Joint Venture:** This implies partial induction of private ownership from 25 to 50 per cent or even more in a public sector enterprise, depending upon the nature of the enterprise and state policy in this regard. Three kinds of proposals have been put forward:

   i) 26 per cent ownership by the private sector (banks, mutual funds, corporations, or individuals) and workers also to be included to the extent of 5 per cent equity to be transferred to them. However, in this situation, veto power remains with the public sector against the private sector.

   ii) Government retains 51 per cent equity and sells 49 per cent equity to the private sector. Although the basic character of the enterprise remains unaltered and it continues to be a public sector unit, it introduces a big share for the private sector.

   iii) 74 per cent of the equity is transferred to the private sector and the Government retains 26 per cent with the added provision of Government veto power and minority control over major corporate decisions.

   These three variants of privatisation indicate different degrees of ownership by the private sector in the joint venture. The basic aim of the transfer of ownership is that it will enable the joint venture to improve productivity of assets and convert them into profitable concerns. However, there are serious doubts whether the first variant will be able to achieve the desired results, because the Government continues its domination with 74 per cent ownership and thus, the private sector only plays a subordinate role. This variant may help to acquire to some extent resources from the private sector, but whether it will change the character of enterprise and bring about operational efficiency is seriously doubted by the critics.

However, the second variant introduces substantial transfer of ownership, i.e. 49 per cent of the share to the private sector. Although majority ownership continues with the public sector, but the private sector, being a big partner, is likely to acquire a significant role in the decision-making process. It has the potential of improving the efficiency of the enterprise.

It is really the third variant which transforms the basic structure of enterprise and transfers 74 per cent ownership to the private sector. It implies that decision-making power in all policy matters is transferred to the private sector. The operational control rests with the private sector and it can, therefore, infuse new work culture in the enterprise. Although the Government has the veto power, it cannot use it frequently, because in such a situation, it will damage the emerging culture of cost reduction, operational efficiency and the profitability of the enterprise. The state will regulate only to the extent of maintaining consistency with macro-economic goals of the state. Private sector will occupy a dominant position in the management and operation of the enterprise.

c) **Workers' Co-operative:** Another form of privatisation is transfer of ownership of a loss-making concern to the workers. Mr. R. Ganpati, former Chairman of the Board of Industrial and Financial Reconstruction (BIFR) is of the view: "If more managements are divested of control of their companies and workers' co-operatives set up in their place, promoters may be galvanised into curing their sick units." The basic logic of the proposal is that workers besides receiving wages for work, would also be entitled to a share in ownership dividend. Since workers' personal interest is linked to the interest of the enterprise, the workers are likely to work hard to increase productivity so that they can earn more. Such schemes were introduced in Kamani Tubes, Central Jute and Mewar Textiles, Hoist O' Mech and Calcutta Chemicals etc. But for a few experiments which yielded positive results at least in the short run, it became difficult to expand the coverage of such proposals. Neither did any Government show any commitment to the idea of workers' co-operatives. Consequently, this form of privatisation did not assume a significant role in economic reform.

d) **Token Privatisation:** This implies the sale of 5 per cent or 10 per cent shares of a profit-making public sector enterprise in the market with the objective of obtaining revenue to reduce budget deficit. This is also referred to as **'deficit privatisation'.** Finance Ministers in India have been undertaking such privatisation to reduce their budget deficits.

This policy has also been referred to as **'disinvestment'.** It was customary for finance ministers to set targets for disinvestment during a year.

It may be noted that total receipts from disinvestment were of the order of Rs. 45,035 crores in 2003-04 and the total investment in Central Government enterprises was of the order of Rs. 3,33,475 crores in 2003. Thus, total disinvestment proceeds work out to be 13.5 per cent of total investment in PSUs. The entire proceeds were used to finance budget deficits. Consequently, this kind of disinvestment was severely criticised because these were the highly profitable PSUs which were disinvested. It was compared to 'selling the family silver to pay the grocer's bills'.

Table 7.1: Targeted and Actual Disinvestment from April 1991 onwards

Rs. crores

Year	Targeted Receipts	Actual Receipts
1991-92	2,500	3,038
1992-93	2,500	1,913
1993-94	3,500	Nil
1994-95	4,000	4,853
1995-96	7,000	362
1996-97	5,000	380
1997-98	4,800	902
1998-99	5,000	5,371
1999-00	10,000	1,829
2000-01	10,000	1,870
2001-02	12,000	5,632
2002-03	12,000	3,348
2003-04	14,500	15,547
2004-05	4,000	2,765*
Total	**96,800**	**47,800**

* Upto December 2004.

Source: Government of India, *Economic Survey (2003-04) and (2004-05).*

Out of the various forms of privatisation, the most acceptable is the joint venture in which the share of the private sector is kept at either 49 per cent or 74 per cent. But a mere change of ownership will not bring about the much-desired increase in productivity and profitability. For this purpose, other supporting measures such as linking wages to productivity, changing promotion policy so as to base it on the efficiency of the worker rather than merely on seniority principle and changing the organisation culture of the enterprise are important variables so that a competitive environment is created in which efficiency pricing becomes a norm.

Check Your Progress 1

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) What are the different major constituents of economic reforms? Are they linked to each other?

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2) Outline the four major objectives of economic reforms.

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   iii) .....

   iv) .....

3) What were the measures contemplated by the Government to liberalise the economy? Do you support all the measures?

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4) What is privatisation? Distinguish between the privatisation of a public sector enterprise and the privatisation of the economy.

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7.2.3 Globalisation to Integrate the Indian Economy with the World Economy

Globalisation is the process of integrating the various economies of the world without creating any hindrances in the flow of goods and services, technology, capital and even labour or human capital. This involves four components:

i) Reduction of trade barriers in the form of custom duties or quantitative restrictions or quotas so as to permit free flow of goods and services among different economies;

ii) Creation of an environment in which free flow of capital (or investment) can take place between nation-states;

iii) Creation of an environment for free flow of technology; and

iv) Last but not the least, from the point of view of developing countries, creation of an environment in which free flow of labour or human resources can take place among different countries of the world.

The advocates of globalisation, more especially from developed countries, limit the scope of globalisation to only three parameters, viz., free flow of goods and services, free flow of technology and free flow of capital. They insist that the debate on globalisation be conducted within these parameters set by them. However, majority of economists from the developing countries consider this definition to be incomplete. In case, the ultimate aim is to integrate the world

economies as a 'global family', then fourth component, viz., unrestricted movement of labour and human resources has to be incorporated within the scope of globalisation. But the entire issue whether debated at the World Bank or IMF or World Trade Organisation (WTO) ignores the free flow of labour as an essential component of globalisation. More recently, the Report of the *World Commission on Social Dimension of Globalisation* set up by the ILO has taken up the question of human flows and movement of labour among nation-states and the need for reducing barriers in this regard.

Globalisation is really an extension of the process of liberalisation in the international domain. It, therefore, signifies *internationalisation plus liberalisation.* Stiglitz in his book '*Globalisation and its Discontents'* defines globalisation in the following words: "Globalisation is the closer integration of the countries and peoples of the world which has been brought about by the enormous reduction of costs of transportation and communications, and the breaking down of artificial barriers to the flow of goods and services, capital, knowledge, and (to a lesser extent) people across borders." Jagdish Bhagwati also similarly defines globalisation in the following manner: "Economic globalisation constitutes integration of national economies into the international economy through trade, direct foreign investment (by corporations and multinationals), short-term capital flows, international flow of workers and humanity generally, and flow of technology."

Advocacy of Globalisation

In support of the movement for globalisation, the following arguments are put forth:

i) Globalisation promotes foreign direct investment and, thus, it enables developing countries to raise capital without incurring international indebtedness.

ii) Globalisation helps developing countries to make use of and adapt technologies developed by advanced countries without undertaking heavy expenditures in Research and Development (R&D).

iii) Globalisation widens the access of developing countries to export their goods and services to developed countries. Similarly, globalisation enables consumers in developing countries to acquire quality consumer goods, especially consumer durables, at relatively much lower prices.

iv) Globalisation implies faster diffusion of knowledge and, thus, it enables developing countries to attain international standards of production and productivity.

v) Globalisation by reducing tariffs and quantitative restriction increases the share of foreign trade as a per centage of GDP.

In brief, the advocates of globalisation consider it as the engine of growth, technological advancement, raising levels of productivity, enlarging employment and bringing about poverty reduction with modernisation. In nutshell, globalisers are of the view that import substitution path of development is restrictive and instead, economies for their growth and technical advancement should promote export-led growth. India has opted for the strategy of export-led growth during the last 15 years. Consequently, exports as a per centage of GDP have gone up from 5.8 per cent in 1990-91 to 11.1 per cent in 2004-05. Along with this, imports

have also gone up from 8.8 per cent of GDP to 13.8 per cent during the same period. Similarly, foreign direct investment flows which were a mere trickle in 1990-91 of the order of $97 million shot up to $6,130 million in 2003-04. Another major benefit of globalisation has been the sharp increase in the export of invisible items, especially software exports. A unique achievement of globalisation is the increase of our net software export earnings to a level of $23.4l billion in 2003-04. There is no doubt that India has started thinking in terms of reaching international standards in productivity and thus competing effectively in the global market.

Check Your Progress 2

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) What is globalisation? Enumerate the different components of globalisation.

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2) What are the major arguments supporting globalisation?

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3) Globalisation promotes a strategy of export-led growth in place of import substitution strategy? Do you consider it to be a correct approach? Give arguments in support of your view.

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7.3 ROLE OF THE PUBLIC SECTOR

7.3.1 Redefining the Role of the Public Sector

Economic Reforms necessitated reconsideration of the role of the public sector. Government was of the view that public sector had not generated internal surplus to a sufficient degree. On account of its inadequate exposure to competition, the public sector has developed a high cost structure. To provide a solution to the problems of the public sector, the Government decided to adopt a new approach towards the public sector. The main elements of the new approach were:

i) The existing portfolio of public investment would be reviewed with a greater sense of realism to avoid areas where social considerations were not paramount or where the private sector would be more efficient;

ii) Enterprises in areas where continued public sector involvement was judged appropriate would be provided a much greater degree of managerial autonomy;

iii) Budgetary support to public enterprises would be progressively reduced;

iv) To provide further market discipline for public enterprises, competition from the private sector would be encouraged and part of the equity in selected enterprises would be disinvested; and

v) Chronically sick public enterprises would not be allowed to incur heavy losses.

In pursuance of the new approach, the following measures were taken:

a) The number of industries reserved for the public sector was reduced from 17 to 8. Even in these areas, private sector participation would be allowed selectively. Joint ventures with foreign companies would be encouraged.

b) Public enterprises that were chronically sick and unlikely to be turned-around would be referred to the Board for Industrial and Financial Reconstruction (BIFR) for rehabilitation or restructuring.

c) The existing system of monitoring public enterprises through Memoranda of Understanding (MOU) was strengthened with primary emphasis on profitability and rate of return.

d) Upto 20 per cent of government equity in selected public enterprises was disinvested through mutual funds.

To get rid of surplus workers, Schemes of Voluntary Retirement were initiated. The main purpose was to effect reduction of workers with minimum adverse impact of the adjustment process. A National Renewal Fund (NRF) was created to provide training and redeployment of workers, besides providing voluntary retirement compensation.

7.3.2 Government Policy towards Public Sector since 1991

A review of the measures to restructure public enterprises reveals that the Government was anxious to restrict public sector to areas where social considerations are paramount. The Government was keen to grant managerial autonomy to PSUs but insisted that they demonstrate a better record of cost reduction, profitability and rate of return. It expressed its clear intention of reducing the size of surplus workforce by the use of voluntary retirement scheme (VRS). Although government promised training and redeployment of workers seeking VRS, but practically nothing was done in this regard since the entire National Renewal Fund was used to make provision for Voluntary Retirement Compensation. In addition, the Government intended to close down chronically sick PSUs which were incurring losses year after year.

7.3.3 Problems Associated with Privatisation

In a democratic society, it is not possible to carry out privatisation in total disregard of the interests of workers. There may exist a strong case for privatisation of

certain PSUs, but it is increasingly difficult to push through proposals of privatisation in reality.

With the emergence of strong trade unions in India, privatisation in the sense of total denationalisation is not acceptable to trade unions. Sometimes, the Government sends feelers in the form of statement of Ministers that it intends to denationalise banks, insurance companies, power generation companies, mining of coal etc. but it sets in motion immediate and sharp reactions from trade unions of all shades. INTUC which is affiliated to the Congress and BMS which is affiliated to BJP have opposed all such moves, even during the period when their parent political parties were in power at the Central Government level. CITU, HMS and AITUC have also opposed all such moves against denationalisation.

The trade unions of all shades – left, centre and right – were all opposed to privatisation of profit-making PSUs. Consequently, the Government is forced to slowdown its pace of disinvestment.

Secondly, it is a fraudulent practice on the part of the state to use book value of net assets. This results in gross under-valuation of assets and, consequently, the assets are transferred to big business at throw away prices and this is the cause of sharp criticism by trade union leaders.

Thirdly, is the aim of privatisation to encourage corporatisation and thus provide benefit to big business houses, or is it aimed at exploring the other forms of privatisation like workers' co-operatives to find a more equitable solution of the problem of sickness? The experience of Kamani Tubes – a loss-making private sector company is an eye opener because the workers' co-operative was able to convert a loss-making unit into a profit-making unit in a span of three years. This only suggests that such experiments may be replicated. There should a right of pre-emption for the workers to run a sick unit. It is only when the workers refuse to avail of the offer that the sick unit be transferred to big business.

Fourthly, another major cause of resistance is the facile manner in which the proposals about retrenchment of workers are made. Workers do not consider Voluntary Retrenchment Scheme (VRS) as the solution to the problem of sickness of PSUs. Mr. Sanat Mehta brought out the stark reality that "in the majority of cases, the workers had to wait for relief for a period of 1.5 to 4 years. Such a long wait resulted in the defeat of the very purpose for which the scheme was formulated, namely, to settle workers reasonably in the transitional period before they find alternative employment."

Lastly, the absence of a social security system in India in contrast to well-established social security systems in developed countries is another major cause of resistance by trade unions to VRS. Employers consider payment of VRS as a burden on them, and not as a legitimate claim of the workers. So they use all kinds of legal and non-legal methods to delay payments of VRS. In state owned enterprises, bureaucratic delays frustrate the workers to receive the much-promised golden handshake.

Unless the problems associated with privatisation are taken care of in a proper and honest manner, the resistance to privatisation will continue. This was one of the reasons for the defeat of the NDA in 2004 General Election, since it tried to

ride rough shod over the interests of workers in its over-zealous attitude towards privatisation. The Congress-led UPA government has, therefore, outlined a more humane approach in this regard. National Common Minimum Programme states:

> "The UPA is pledged to devolve full managerial and commercial autonomy to successful, profit-making companies operating in a competitive environment. *Generally*, profit making companies will not be privatised."
>
> "All privatisation will be considered on a transparent and case-to-case basis. The UPA will retain existing 'navratnas' companies in the public sector, while these companies raise resources from the capital market. While every effort would be made to modernise and restructure sick public sector companies and revive sick industry, chronically loss-making companies will either be sold off or closed after all workers have got their legitimate dues and compensation. The UPA will induct private industry to turn-round companies that have potential for revival."
>
> "The UPA government believes that privatisation should increase competition, not decrease it. It will not support the emergence of any monopoly that only restricts competition. It believes that there must be direct link between privatisation and social needs – for example, the use of privatisation revenues for designated social service schemes. Public sector companies and nationalised banks will be encouraged to enter capital market to raise resources and offer new investment avenues to retail investors."
>
> "LIC and GIC will continue to be in the public sector and play their social role."

However, despite all the pious promises, the real test of UPA promises regarding the public sector policy will lie in their implementation.

Check Your Progress 3

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) What are the essential elements of the Government policy on the role of the public sector as laid down in the era of economic reforms started in 1991?

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2) What are the problems associated with privatisation in a democratic society?

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3) What are the fears in the minds of workers regarding privatisation of public sector units?

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4) What steps can be taken by the Government to reduce the opposition of trade unions towards privatisation?

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5) Enumerate the main components of the policy on public sector as outlined in the National Common Minimum Programme of the UPA government.

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7.4 LET US SUM UP

This unit has been devoted merely to describe the scope and the direction of economic reforms initiated after 1991. The LPG model has been in operation for nearly a decade and a half. It would, therefore, be proper to study the impact of this model on the Indian economy. Whether it has ushered in a process of development with a human face will be studied in the next unit.

7.5 EXERCISES

1) What are the various forms of joint ventures conceived in India? Which one of these do you consider as the most acceptable and desirable for raising productivity and profitability of a joint sector enterprise?

2) What is deficit privatisation? Is it desirable to disinvest public enterprises to meet budget deficits?

3) What is the rationale behind worker's co-operatives? Even though workers' co-operatives succeeded in some cases, the model could not be adopted on a large scale. Why?

4) India followed the policy of disinvestment for over 14 years. Did it succeed in stantial privatisation or was it used as a method of meeting budget deficits?

7.6 KEY WORDS

Liberalisation: It implies the removal of restrictions like those of licensing in the national economy and reduction of trade barriers in the international economy.

Privatisation: It implies the induction of private ownership and management in a public sector undertaking. In a broader sense, it implies the process of increasing the share of the private sector in the national economy.

Denationalisation: It implies the complete transfer of ownership of a public sector enterprise into private hands.

Joint Venture : It implies partial introduction of private ownership from 25 to 50 per cent, or even more in a public sector enterprise, depending upon the nature of the enterprise and state policy.

Token Privatisation: It implies the sale of 5 per cent or 10 per cent shares of a profit-making public sector enterprise in the market with the objective of obtaining revenue to reduce budget deficit.

Deficit Privatisation: It implies the sale of the shares of a public sector enterprise to obtain revenue to reduce budget deficit.

Disinvestment: It is used as a synonym for privatisation.

7.7 SOME USEFUL BOOKS

Bhagwati, Jagdish (2004); *In Defense of Globalisation.* Oxford University Press, U.K.

Datt, Ruddar & Sundharam, K.P.M. (2005); *Indian Economy*, S. Chand & Company Ltd., New Delhi.

ILO (2004); *A Fair Globalisation: Creating Opportunities for All,* Report of the World Commission on the Social Dimension of Globalisation.

Stiglitz, Joseph E. (2002); *Globalisation and its Discontents*, W.W. Norton & Company.

Tidsell, Clem & Sen, Raj Kumar (ed) (2004); *Economic Globalisation*.

7.8 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) The different major constituents of economic reforms are: liberalisation, privatisation and globalisation. These are linked to each other.

2) i) To liberate the Indian industrial economy from the bureaucratic controls.

   ii) To introduce liberalisation with a view to integrate the Indian economy with the rest of the economy.

   iii) To remove restrictions of MRTP Act in increasing the investments and also remove restrictions on direct foreign investment.

UNIT 8 CRITIQUE OF ECONOMIC REFORMS

Structure

8.0 OBJECTIVES

In unit 7, you were introduced to the various aspects of economic reforms. Unit 8 is devoted to the assessment of economic reforms. For this purpose, it is necessary to define certain parameters for judging the reform process. Once that is done, it would be of interest to understand the developments in the Indian economy during the last 15 years. After going through this unit, you will be able to:

1) identify the parameters for assessment of economic reforms;
2) assess the extent to which the reform process has succeeded in achieving the economic and soical objectives; and
3) state the positive and negative aspects of reform process.

8.1 INTRODUCTION

Economic Reforms were introduced in 1991. It is now nearly 15 years since the reform process was initiated. This cannot be treated as a short period to assess the impact of economic reforms. It may be pointed out that there is near unanimity among political parties regarding the implementation of economic reforms.

Congress Party being the author of economic reforms is committed to them. The Bharatiya Janata Party (BJP) accepted economic reforms. Rather during its rule (1999-2004), it pushed forward the chariot of economic reforms with greater zeal than even the Congress Party. Thus, the two major political parties – Congress and the BJP – have a common agenda of economic reforms. The left political parties – CPI, CPI (M) and Janata Dal (United) are not opposed to economic reforms, but they repeatedly emphasise that while implementing the reform agenda, the interests of labour and the common man should not be ignored and the reform process should not follow the dictates of capitalist lobbies. Even regional parties like DMK, AIDMK, Samajwadi Party, Rashtriya Janta Dal have also been wooing foreign capital to undertake investments in their states. In short, a consensus has emerged among the political parties that there is no alternative to economic reforms in the present world economic situation. So every political party is keen on accelerating the pace of economic reforms to acquire higher GDP growth, enlarge investment in infrastructure, persuade Indian big business and multinationals to promote investments. There is a strong feeling that the levels of living of the people cannot be improved unless the growth process is accelerated and the country achieves a sustained growth of GDP of 7-8 per cent for over a decade or two. Obviously, the country must define the parameters for assessing economic reforms.

8.2 PARAMETERS FOR ASSESSING ECONOMIC REFORMS

Let it be clearly understood that liberalisation, privatisation and globalisation are means with the help of which the growth process is sought to be accelerated. They should not be considered as ends in themselves. The goals of economic development have been defined in the First and the Second five-year plan. They alone become the parameters for judging the impact of economic reforms. The major goals are:

i) A higher rate of growth of GDP – 7-8 per cent per annum;

ii) Enlargement of the employment potential leading to full employment;

iii) Reduction of the proportion of population below the poverty line;

iv) Promotion of equity or distributive justice so that a better deal is provided to the poor and less well off sections of the society;

v) Reduction of regional disparities between the rich and the poor states of India; and

vi) Improvement in human development in terms of health and education of the population.

It would be useful if a critique of economic reforms is based on the success of economic reforms in achieving these goals.

8.3 CRITIQUE OF ECONOMIC REFORMS

The critique of economic reforms should consider the actual growth rate achieved, its impact on employment and poverty reduction, its impact on labour, its impact on agriculture – the major source of livelihood of over 60 per cent of population,

its effect on balance of trade and balance of payments, its effect on accelerating industrial growth by stepping up domestic and foreign investment, in strengthening economic and social infrastructure and last but not the least, in reducing regional disparities between states. Let us consider the issues in detail.

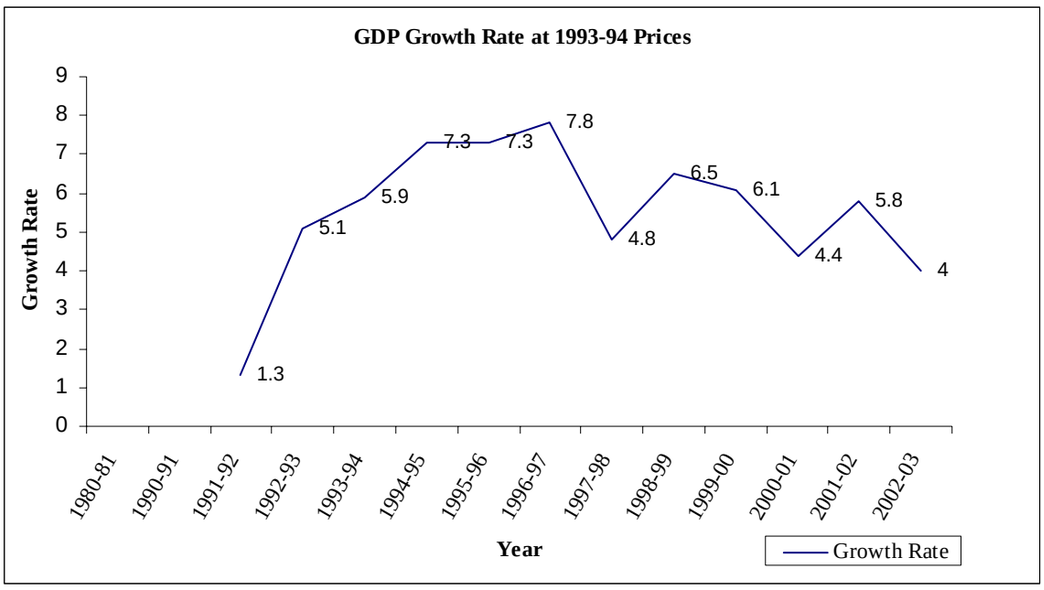
8.3.1 GDP Growth, Employment and Poverty

The advocates of economic reforms point out that the reform process has the potential of accelerating economic growth. After the teething troubles of the just two years – 1991-92 and 1992-1993, growth rate picked up and GDP growth averaged about 7 per cent during 1993-94 to 1997-98 (Refer table 8.1). However, thereafter, the growth process became uneven and even decelerated during 1998-99 to 2002-03 to an average of 5.3 per cent per annum. If we compare the annual average growth rate during the pre-reform period (1980-81 to 1990-91) which was of the order of 5.6 per cent per annum, then the post-reform 12-year period (1990-91 to 2002-03) also shows an average growth rate of 5.5 per cent (Refer table 8.1). Obviously, the claim of the advocates of reforms that they have been able to substantially jack up growth to 6-7 per cent per annum is not borne out by facts. This implies that the reform process has yet to establish its distinct superiority over the pre-reform period.

Table 8.1: GDP Growth Rate at 1993-94 Prices

Year	GDP (Rs. crore)	Growth Rate
1980-81	4,01,128	
1990-91	6,92,871	
1991-92	7,01,863	1.3
1992-93	7,37,792	5.1
1993-94	7,81,345	5.9
1994-95	8,38,031	7.3
1995-96	8,99,563	7.3
1996-97	9,70,083	7.8
1997-98	10,16,594	4.8
1998-99	10,82,798	6.5
1999-00	11,48,367	6.1
2000-01	11,98,592	4.4
2001-02	12,67,945	5.8
2002-03	13,18,362	4.0
Annual Average GDP Growth Rate		
1980-81 to 1990-91		**5.6**
1990-91 to 2002-03		**5.5**

Chart 1: GDP Growth Rate at 1993-94 Prices



8.3.1.1 Economic Reforms and Reduction of Poverty

Dr. S.P. Gupta, former member, Planning Commission has compared the reduction of poverty in the pre-reform period and the post-reform period while delivering the V.B. Singh Memorial Lecture in 1999 at the 41st Annual Conference of the Indian Society of Labour Economics. Dr. Gupta made the startling observation: "In India, the poverty reduction (i.e. per centage of population below the poverty line) over 1983 to 1990-91 was around 3.1 per cent per annum, but it reversed to 1 per cent in the 1990s i.e. between 1990-91 and 1997. In contrast to this, the GDP growth in India between 1983 to 1990-91 was around 5.6 per cent and between 1990-91 and 1997, this is expected to go beyond 5.7 per cent." Dr. Gupta, therefore, underlined the pro-elitist bias of economic reforms. He lamented that there was an inverse relationship between GDP growth and poverty reduction. This is due to the fact that the benefits of growth are being swallowed by the elitist sections of the society and the triple-down of benefits to the poor is very weak.

Similarly, Dr. Gaurav Datt of the World Bank in his article "Has poverty declined since Economic Reforms?" has drawn the following conclusions:

1) While there was a marked decline in both rural and urban poverty rates between 1973-74, there is no sign of anything comparable thereafter.

2) For the rural sector, for the period 1973-74 and 1990-91, headcount index of poverty declined at the annual rate of 2.7 per cent, the rate of decline since then (i.e. in the post-reform period) is not significantly different from zero. (Refer table 8.2)

3) For the urban sector, during 1973-74 and 1990-91, headcount index of poverty declined at the annual average rate of 2.2 per cent, the same trend is continued in the post-reform period (1990-91 to 1996-97) at the annual average rate of 2.2 per cent.

4) While the urban sector seems to have continued its march of poverty reduction in the process of growth, rural poverty was choked off by lack of rural growth.

Dr. Gaurav Datt has identified stagnation in rural growth as the basic cause of slowdown in poverty reduction. This naturally puts a question mark on the very nature of the reform process in terms of rural welfare.

Table 8.2: Poverty in India 1973-1997

Period of NSS Survey	Per cent of Population below Poverty Line (Headcount Index)	
	Rural	**Urban**
Oct. 73 – July 74	55.72	47.96
July 77 – June 78	50.60	40.50
Jan 83 – Dec 83	45.31	35.65
July 86 – June 87	38.81	34.29
July 90 – June 91	36.43	32.76
Pre-reform July 89-June 91	**35.37**	**33.08**
July 93 – June 94	36.66	30.51
July 95 – June 96	37.15	28.04
Jan 97 – Dec 97	35.78	29.99
Post-reform July 95-Dec 97	**36.47**	**29.02**

Source: Gaurav Datt, Has poverty declined since Economic Reforms? *Economic and Political Weekly*, December 11-17, 1999.

8.3.1.2 GDP Growth, Employment Growth and Poverty

The basic question which needs a convincing explanation is: Why is that though GDP growth during the 1990s (especially after 1993-94) was quite high, it did not result in a corresponding decline in poverty? The answer to this lies in the slowdown of employment growth. If poverty implies either unemployment or under-employment or absence of good quality employment, then data provided by the National Sample Survey Organisation (NSSO) reveals that total employment increased from 3,026 lakhs in 1983 to about 3,568 lakhs in 1990-91 and then rose further to 3,829 lakhs in 1997-98 (Refer table 8.3). The rate of growth of employment works out to be 2.39 per cent per annum during 1983 and 1990-91. This was broadly equal to the rate of growth of labour force during the period. It was expected that if the growth rate of employment is sustained during the next decade, it would be possible to reduce the backlog of unemployment with the expected decline in growth of labour force. But so far as employment is concerned, a very disappointing situation arose in the post-reform period (1990-91 to 1997-98) when the growth rate of employment sharply declined to a mere 1.0 per cent per annum. Although the reform process concentrated at the corporate yet the growth rate of employment in organised sector was merely 0.6 per cent. This was just one-third of the growth of employment witnessed in the pre-reform period. So far as the unorganised sector is concerned, the growth rate of employment which was of the order of 2.41 per cent during the pre-reform period (1983 to 1990-91), also declined to 1.1 per cent in the post-reform period. Obviously, the trickle down effects of growth did not benefit the poor. Dr S.P. Gupta, therefore, mentions: "All these trends make one rethink the utility of an exclusive policy on 'GDP growth' in resolving poverty or employment. In contrast, it has been observed that high growth in employment in India has almost always been associated with some reduction in

poverty. For example, the period of high growth of employment in the 1980s with a comparatively lower GDP growth has witnessed a significant reduction in poverty. In the 1990s, as hypothesised, a low growth of employment is seen to be associated with an increase in poverty".

Table 8.3: State of Employment in India (1983-1997)

In lakhs

Year	Total	Organised Sector	Unorganised Sector
1983	3,026.0	240.1	2,785.9
1990-91	3,567.6	270.6	3,297.0
1997-98	3,828.5	282.5	3,546.0
Growth Rate of Employment Annual Average (%)			
1983 to 1990-91	2.39	1.73	2.41
1990-91 to 1997-98	1.0	0.6	1.1

Source: Computed from data provided by *Household Consumption Survey* (NSSO), Government of India.

8.3.2 Impact of Economic Reforms on Labour

It would be of interest to study the industrial relations scenario in the pre-reform and post-reform period. Data provided in table 8.4 reveals that during 1981-90 – the decade before the introduction of economic reforms, a total of 402 million mandays were lost, out of which 216 million (53.8 per cent) were accounted for by strikes and the remaining about 186 million (46.2 per cent) were due to lockouts. However, in the decade following economic reforms i.e. 1991-2000 – the post reform period witnessed a decline in the total number of mandays lost to 230 million, out of which strikes accounted for 92 million (39.8 per cent) and lockouts for 138 million (60.2 per cent). This implies that the proportion of mandays loss due to lockouts was much higher in the post-reform period than in pre-reform period. **As a result of the policies of privatisation followed by the state, employers got emboldened and this increased employers' militancy**. Even during the 3-year period (2001-03), the situation further worsened and the proportion of mandays lost due to lockouts went up to 77 per cent as against only 23 per cent due to strikes.

Table 8.4: Mandays lost in Strikes and Lockouts

Period	Total Number of Mandays Lost (in Million)		
	Strikes	Lockouts	Total
Pre-reform Period	216.4	185.7	402.1
(1981-90)	(53.8)	(46.2)	(100.0)
Post-reform Period	91.6	(138.5)	230.1
(1991-2000)	(39.8)	(60.2)	(100.0)
2001-2003	18.4	62.2	80.6
	(22.9)	(77.1)	(100.0)

Note: Figures in brackets are per centages of total mandays lost.

Source: Calculated from the data provided in the Ministry of Labour, *Annual Report (2001-2002)* and *Economic Survey (2004-05).*

Not only that, workers have to suffer as a result of closures. Management used closures as a device to get rid of even permanent workers. During 1991-97, as a result of 1,687 closures, 1.2 lakh workers lost their jobs. Similarly, lay-offs were resorted to as a cost-cutting device and during the 7-year period (1991-97), 4.91 lakh workers were laid off. On the plea of redundancy, during the same period, a total 20,720 workers were retrenched.

Table 8.5: Per centage Distribution of Workforce

	Self Employed	Wage Employment	Casual Labour
1988	53.6	15.2	31.2
1994	51.9	14.7	33.5
1996	52.4	15.9	32.8
1997	52.6	14.5	32.9
1998	50.7	12.3	37.0

Source: Ashok Mathur (2000), Economic Reforms, Employment and Non-Employment, in P.D. Hajela and M.P. Goswami, *Economic Reforms and Employment.*

The employers have been using every device in the post-reform period to increase the component of casual labour so that they can bring about cost-reduction by not paying them dearness and other allowances. It may be noted that the share of casual labour which was 31.2 per cent in 1988 rose to 37.0 per cent in 1998.

All these developments indicate that labour was adversely affected by economic reforms. Although the Government has not formally accepted an exit policy, yet in practice, the managements are following an exit policy. The workers are being pushed from more secure employment to insecure employment as a consequence of casualisation of workforce.

8.3.3 Increase in Productivity and Real Wage Earnings

Labour has been charged that whereas it presses for higher wages through trade unions, it has failed to raise productivity. Shariff and Gomber (1999) studied the problem of increase in labour productivity and real earnings of regular wage and salaried employees. Their study revealed that during 1983-88, whereas labour productivity increased by 3.16 per cent, real wage earnings rose by 7 per cent. But during 1988-94, whereas labour productivity increased by 3.32 per cent, increase in real earnings showed a miserable increase of 1.0 per cent. Obviously, gains of productivity in this period were transferred to the workers to the extent of only 1.0 per cent and the rest were pocketed by the employers. This had an adverse effect on labour welfare.

There is a shift in the attitude of employers in the post-reform period. Instead of treating labour as a partner in the production process, the employers started treating labour as a mere instrument of production which can be dispensed with when in the judgement of the employer, it is no longer useful. Voluntary Retirement of old workers and their replacement by younger ones is a reflection of this attitude. In developed countries, where social security systems are well-developed, the process of downsizing labour is relatively less painful as compared to downsizing in under-developed countries. Workers are entitled to a dole in developed countries and thus can obtain a basic minimum for their survival, but

in under-developed countries like India, downsizing which is another name for retrenchment results in depriving the workers of their livelihood. It is due to this reason that trade unions are opposed to an exit policy, or the right to hire and fire by the employers. This has been replaced by a softer term 'labour flexibility' which also implies the right to retrench workers.

The Government and the industrial lobbies argue that they will provide safety net for retrenched or laid-off workers, but Joseph Stiglitz criticising this policy mentioned: "There is no safety net that can fully replace the security provided by an economy running at full employment. No welfare system will ever restore the dignity that comes from work." Stiglitz, therefore, urged, "workers rights should be a central focus of development".

8.3.4 Neglect of Agriculture in the Reform Era

Table 8.6 provides us the growth of the various components of GDP. Whereas during 1980-81 to 1990-91, the annual average GDP growth was 5.6 per cent, during the post-reform period (1990-91 to 2001-02), it was of the order of 5.7 per cent. This implies that average growth rate of GDP in the two period was nearly equal. However, it may be noted that GDP in agriculture which showed a growth rate of 3.7 per cent per annum during the pre-reform period (1980-81 to 1990-91) witnessed a decline in the 11-year post-reform period to 2.9 per cent. This was due to the neglect of agriculture in the period of economic reforms, because the reform process simply emphasised industry (manufacturing), more especially the growth of the corporate sector and infrastructure like transport and communications.

Table 8.6: GDP and GDP Growth Rates in Different Sectors

Sector	GDP Contribution (Rs. crores)			Annual Average Growth	
	1980-81	1990-91	2001-02	2001-02 / 1990-91	1990-91/ 1980-81
Agriculture	1,67,770	2,42,012	3,33,274	2.9	3.7
	(41.8)	(34.9)	(26.2)		
Manufacturing, Construction,	86,605	1,69,703	3,09,557	5.6	7.0
Electricity, Gas and Water Supply	(21.6)	(24.5)	(24.4)		
Trade, Hotels, Transport and	73,846	1,29,780	2,97,831	7.8	5.8
Communications	(18.5)	(18.7)	(23.5)		
Finance, Insurance, Real Estate	26,156	66,990	1,57,746	8.1	9.9
and Business Services	(6.5)	(9.7)	(12.4)		
Public Administration, Defence	46,751	84,380	1,69,537	6.6	6.1
and Other Services	(11.6)	(12.2)	(13.4)		
GDP at Factor Cost	4,01,128	6,92,871	12,67,945	5.7	5.6
	(100.0)	(100.0)	(100.0)		

Note: Figures in brackets are per centages of GDP of factor cost.

Source: Compiled and computed from the data given by Central Statistical Organisation in *Economic Survey (2004-05)*.

Even if we consider the growth of foodgrains production, it increased from 129.6 million tonnes in 1980-81 to 176.4 million tonnes in 1990-91, indicating a growth

rate of 3.1 per cent per annum. But during the 13-year period of economic reform, production of foodgrains increased from 176.4 million tonnes in 1990-91 to 212.0 million tonnes in 2003-04, indicating an annual average growth rate of 1.4 per cent which was lower than the growth rate of population at around 1.9 per cent. Obviously, there was neglect on the food front which does not usher well for the Indian economy. For this, the main culprit was the decline in gross capital formation in agriculture, more especially public sector investment declined from Rs. 4,967 crores in 1994-95 to Rs. 4,397 crores in 2002-03 (at 1993-94 prices). Since public sector investment largely takes care of irrigation and rural investment, it adversely affected foodgrains production. Moreover, the benefits of green revolution in Punjab, Haryana and Uttar Pradesh have reached a near saturation point and levelled off. The country could have achieved higher levels of foodgrains production by extending the area under irrigation in backward states. This did not happen and, consequently, agricultural growth suffered a decline.

8.3.5 Economic Reforms and Industrial Growth

Economic reforms were mainly intended to remove obstacles so that investment in industry may be accelerated. With this end in view, industrial licensing was abolished in all but 15 industries. Consequently, the reform process was able to dismantle the system of industrial licensing so that industrial production growth could be accelerated.

Despite all this, facts do not support any sharp acceleration of industrial production. Rather, they indicate that the index of industrial production which showed a growth rate of 7.8 per cent in the pre-reform period (1981-82 to 1990-91), decelerated to 5.8 per cent during the post-reform period (1993-94 to 2002-03).

Table 8.7: Annual Average Growth Rate of Industrial Production

Per cent per annum

Sector	1981-82 to 1990-91	1993-94 to 2002-03
General Index	**7.8**	**5.8**
a) Manufacturing	7.6	6.9
b) Electricity	9.0	5.7
c) Mining and Quarrying	8.3	3.8

Source: Calculated from the RBI, *Handbook of Statistics on the Indian Economy (2003-04).*

Data provided in table 8.7 reveal that the main cause of decrease in the growth of Index of Industrial Production (IIP) was a sharp decline in electricity generation from 9.0 per cent during the pre-reform period to 5.7 per cent in the post-reform period. In mining and quarrying, the index of production slumped from 8.0 per cent to 3.8 per cent.

Data presented in table 8.8 reveal that in capital goods, there was a sharp decline in growth rate from 11.5 per cent during 1981-82 to 1990-91 to a low level of 6.6 per cent during 1993-94 to 2002-03. Even in basic goods, there was decline in growth rate from 7.0 per cent to 5.4 per cent. In durable consumer goods, also, index of growth rate declined from 13.9 per cent to 10.1 per cent.

Table 8.8: Average Annual Growth Rate of Industrial Production – Use-based Classification

Sector	1981-82 to 1990-91	1993-94 to 2002-03
a) Basic Goods	7.0	5.4
b) Capital Goods	11.5	6.6
c) Intermediate Goods	5.9	7.2
d) Consumer Goods	6.7	7.2
i) Durables	13.9	10.1
ii) Non- durables	5.5	6.5
General Index	**7.8**	**5.8**

Source: Computed from RBI, *Handbook of Statistics on the Indian Economy (2003-04).*

From this analysis, it becomes evident that although the wide-ranging industrial reforms were aimed at boosting industrial growth, but the ground reality as revealed by the data only points to the failure of the reform process. The failure was more pronounced in basic and capital goods sectors as also in consumer durables.

8.3.6 Performance of Public Sector Enterprises

Data reveal that the performance of the much-maligned public enterprises has shown a distinct improvement during the last 9 years. Gross profit as a per centage of capital employed was 11.61 per cent in 1993-94, it improved to 15.88 per cent in 1995 and further improved to 17.5 per cent in 2002-03. Similar trend was noticed in net profit which improved from 2.84 per cent in 1993-94 to 7.7 per cent in 2003-04. This indicates an improvement in the performance of Central Government Enterprises. The question that becomes relevant is: Is it, therefore, desirable to undertake disinvestment of CPSUs? The answer on all practical considerations is clearly in the negative. It would be far more rewarding if the Government gave them greater autonomy to undertake business decisions. By 2002-03, a total 100 PSUs signed Memorandum of Understanding (MOUs). A review of performance reveals that out of 100 enterprises, 45 were rated as excellent, 19 very good and 14 as good. If 78 enterprises out of a total of 100 have shown an improvement in performance, then it becomes evident that it is more desirable to innovate measures to improve their performance, rather than weaken them by undertaking disinvestment.

Check Your Progress 1

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Enunciate the major parameters of assessing economic reforms in India.

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2) Do you think that the reform process has established its distinct superiority in terms of GDP growth when compared with the performance of the Indian economy in the pre-reform period?

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3) Do you consider that the effect on employment and poverty reduction has been satisfactory in the post-reform period as compared to the pre-reform period? Give reasons in support of your answer.

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8.3.7 Economic Reforms, India's Foreign Trade and Balance of Payments

One of the major objectives of economic reforms was to boost exports so that India's balance of trade position improves. Since India was having a positive balance in net invisibles, the invisibles were able to partially wipe out trade deficit and the balance of payments deficit. It would be of interest to review the situation. For this purpose, the post-reform period is further divided into three sub-periods.

During the 5-year period (1990-91 to 1995-96), exports increased from $18,477 million in 1990-91 to $32,311 million in 1995-96, indicating a growth rate of 11.8 per cent. Similarly, imports grew from $27,194 million in 1990-91 to $43,670 million in 1995-96, indicating a growth rate of 9.3 per cent. The annual average exports were of the order of $23,797 million and imports were $30,339 million, resulting in a negative balance of trade of $6,542 million. Surplus of net invisibles averaged $3,514 million and they wiped out the trade deficit by 53.7 per cent. Consequently, balance of payments was adverse to the extent of an annual average of $3,028 million.

The situation worsened during 1996-97 and 2000-01 and trade balance was unfavourable to the extent of $15,156 million but India was able to get a favourable net invisibles balance of $10,667 million which wiped out the trade deficit to the extent of 70.4 per cent, resulting in a negative balance of payments of the order of $4,489 million which was higher than the annual average in the preceding 5-year period. The annual growth of exports was of the order of 6.3 per cent.

The situation took a turn during the 3-year period (2001-02 to 2003-04) and annual average growth of exports was 12.9 per cent and that of imports was 10.5 per cent. The annual average trade balance deficit was much higher, viz., $12,949 million. But a unique feature was the sharp increase in net invisible of the order of $18,845 million during the 3-year period. Consequently, India had a positive balance on current account of the annual average of $5,896 million. The sharp rise in net visible was primarily the result of a sharp increase in software exports to $11,750 million in 2003-04. Net income from invisibles accounted for 145.5 per cent of trade deficit.

Table 8.9: India's Exports, Imports, Trade Balance and Balance of Payment Post-Reform period (1991-92 to 2003-04)

US $ million

	Exports	Imports	Trade Balance	Net Invisibles	Balance of Payments on current account	1 as % of 2	4 as % of 3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1991-92	18,266	21,064	-2,798	1,620	-1,178	86.7	57.9
1992-93	18,869	24,316	-5,447	1,921	-3,526	77.6	35.2
1993-94	22,683	26,739	-4,056	2,898	-1,158	84.8	71.4
1994-95	26,855	35,904	-9,049	5,680	-3,369	74.8	62.8
1995-96	32,311	43,670	-11,359	5,449	-5,910	73.9	48.0
Annual Average	23,797	30,339	-6,542	3,514	-3,028	78.4	53.7
(1991-92 to 1995-96)							
Average Growth Rate	11.8	9.3					
1996-97	34,133	48,948	-14,815	10,196	-4,619	69.7	68.8
1997-98	35,680	51,187	-15,507	10,007	-5,500	69.7	64.5
1998-99	34,298	47,544	-13,246	9,208	-4,038	72.1	69.5
1999-00	37,542	55,383	-17,841	13,143	-4,698	67.7	73.7
2000-01	44,894	59,264	-14,370	10,780	-3,590	75.7	75.0
Annual Average	37,309	52,465	-15,156	10,667	-4,489	71.1	70.4
(1996-97 to 2000-01)							
Average Growth Rate	6.8	6.3					
2001-02*	44,915	57,618	-12,703	13,485	+782	77.9	106.1
2002-03*	53,774	64,464	-10,690	17,035	+6,345	83.4	159.4
2003-04*	64,723	80,177	-15,454	26,015	+10,561	80.8	168.3
Annual Average	54,471	67,420	-12,949	18,845	+5,896	80.8	145.5
(2001-02 to 2003-04)							
Average Growth Rate	12.9	10.5		34.3			

* Partially revised.

Source: Compiled and computed from RBI, *Handbook of Statistics on the Indian Economy (2003-04)* and *Reserve Bank of India Bulletin*, January 2005.

But as per information about 2004-05, exports were of the order of $79.59 billion while imports were of the order of $106.12 billion, resulting in a huge trade deficit of $26.52 billion – highest recorded so far. Obviously, a liberal import policy, removal of all quantitative restrictions and reduction of import tariffs has resulted in a deepening of adverse trade deficit. As against 24.4 per cent increase in exports, imports have risen by 35.6 per cent. The rise in the import price of crude oil has also led to a sharp increase in imports.

It implies that during the 13-year period of economic reforms, India was able to increase her exports from $18.26 billion in 1991-92 to $79.59 billion in 2004-05, but as against them, imports had shot up from $21.06 billion in 1991-92 to $106.12 billion in 2004-05. Obviously, foreigners have been able to penetrate the Indian market much more than India has been able to extend her reach to foreign markets. This has resulted in a sharp increase in negative trade balance to the tune of $26.52 billion in 2004-05. It may be concluded that export promotion effort was nullified by a relatively larger increase in imports. Unlike China which was able to generate a positive trade balance, India has not succeeded in this regard.

However, India has gained on account of net invisibles and the positive balance of net invisibles has continued its upward trend from $1.6 billion in 1991-92 to $5.45 billion in 1995-96, to a near doubling to $10.78 billion in 2000-01 and reaching a record level of $26.0 billion in 2003-04. In this respect, special mention has to be made of a sharp increase in net software exports rising to $11.75 billion in 2003-04. India has, therefore, been a gainer in net invisibles account.

8.3.8 Economic Reforms and Foreign Investment Inflows

A major objective of economic reforms was to increase foreign investment, which helps to increase capital formation of the economy without creating foreign debt. Foreign investment flows take two forms – foreign direct investment and portfolio investment. Foreign direct investment figures show that it has been gradually increasing from $129 million in 1991-92 to $3,557 million in 1997-98 and rising to a peak of $6,130 million in 2001-02 and then declining to $4,673 million in 2003-04. But as against it, foreign portfolio investment which is considered to be hot money, has shown violent fluctuations. It increased from $0.24 billion in 1992-93 to $3.82 billion in 1994-95 and then continued to decline and became negative to $61 million in 1998-99, but again rose to $3.03 billion in 1999-00 and then continued to decline and was only $0.98 billion in 2002-03. However, it shot up to a record level of $11.38 billion in 2003-04. The sharp fluctuations in portfolio investment have made it an undependable source of foreign funds which is related to the international financial climate. Total foreign investment has increased from $4.15 billion in 1993-94 to 8.15 billion in 2001-02 and to $16.05 billion in 2003-04. Taking the 13-year period (1991-92 to 2003-04), out of a total foreign investment of $70.98 billion, foreign direct investment accounted for $35.35 billion (49.8 per cent) and portfolio investment was $35.63 billion (51.2 per cent). However, it may be mentioned that China has been able to attract a much higher level of foreign investment than India, though the situation has improved so far as India is concerned. For instance, as per *World Investment Report* (2004), FDI flows in China in 2003 was of the order of $53.5 billion while in the case of India, it was merely $4.37 billion.

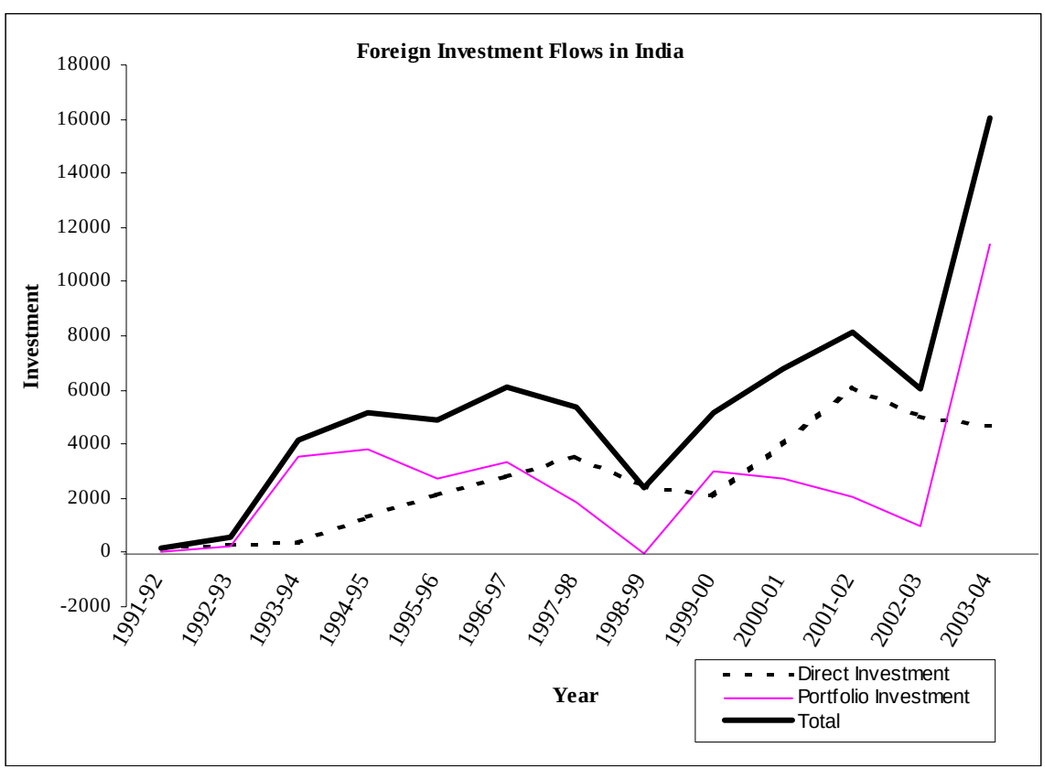
Table 8.10: Foreign Investment Flows in India

(In US $ million)

Year	Direct Investment	Portfolio Investment	Total
1991-92	129	4	133
1992-93	315	244	559
1993-94	386	3,567	4,153
1994-95	1,314	3,824	5,138
1995-96	2,144	2,748	4,892
1996-97	2,821	3,312	6,133
1997-98	3,557	1,828	5,385
1998-99	2,462	-61	2,401
1999-00	2,155	3,026	5,181
2000-01	4,029	2,760	6,789
2001-02	6,130	2,021	8,151
2002-03	5,035	979	6,014
2003-04	4,673	11,377	16,050
Total (1991-92 to 2003-04)	**35,350 (49.8)**	**35,629 (51.2)**	**70,979 (100.0)**

Source: Compiled and computed from RBI, *Handbook of Statistics on the Indian Economy (2001)* and *RBI Bulletin*, January 2005.

Chart 2: Foreign Investment Flows in India



Another problem is the gap between actual flows and approvals. Actual inflows of FDI were barely 26.8 per cent of the total approvals. Total FDI approved as per *Economic Survey* (2003-04) was of the order of Rs. 2,51,431 crores, but actual flows were merely Rs. 67,462 crores from January 1991 to March 2004. This is rather very low. One can understand that there is bound to be a gap between actual flows and approvals because it does take time to actualise a promise, but the gap is too wide in the case of India. It needs to be bridged.

Check Your Progress 2

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) 'India has been able to penetrate foreign markets to a lesser degree than the foreigners have been able to penetrate the Indian market'. Do you agree with this statement. Give facts in support of your answer.

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2) India's record in net invisibles has been commendable. What was the most important factor contributing to it?

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3) Between foreign direct investment and foreign portfolio investment, which one will your prefer? Why?

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8.3.9 Economic Reforms and Infrastructure Growth

Infrastructure data for the pre-reform period (1980-81 to 1990-91) is with 1980-81 as base year and for post-reform period (1993-94 to 2003-04) is with 1993-94 as base year. In that sense, the growth rates are not strictly comparable, but they are indicative of the trend.

Data provided in table 8.11 reveal that in case of saleable steel and cement, growth rates in the post-reform period were higher than in the pre-reform period. In the case of steel, growth rate during 1993-94 to 2002-03 was 9.5 per cent as against only 4.9 per cent in the 1980s. Similarly, in the case of cement, growth rate in the post-reform period was 8.2 per cent as against 4.0 per cent in the pre-reform period. But it may be pointed that in both these cases, the withdrawal of state control in pricing carried out in the 1980s was responsible for the uptrend in the post-reform period.

Table 8.11: Trends in the Growth Rates of Infrastructure Industries

	Index of Infrastructure			Average Growth Rate	
	1980-81	1990-91+	2002-03*	1980-81 to 1990-91	1993-94 to 2002-03
Electricity	100.0	238.9	164.3	9.1	5.6
Coal	100.0	185.7	137.1	6.4	3.6
Saleable Steel	100.0	147.6	227.2	4.9	9.5
Cement	100.0	260.4	303.0	4.0	8.2
Petroleum	100.0	317.9	122.3	12.2	2.2
Petroleum Refinery Products	100.0	186.8	210.9	6.5	8.6
Composite Index	100.0	215.0	172.9	8.0	6.3

+ with 1980-81 as base.

* with 1993-94 as base.

Source: Compiled and computed from RBI, *Handbook of Statistics on the Indian Economy (2003-04).*

However, other infrastructure industries like electricity, coal and petroleum showed lower growth rates in the post-reform period than in the pre-reform period. Electricity generation which is of vital importance indicated a decline in growth rate from 9.1 per cent in the eighties to only 5.6 per cent in the post-reform period. Growth rate of coal declined from 6.4 per cent to 3.6 per cent. The sharpest decline was noticed in petroleum from 12.2 per cent in the eighties to merely 2.2 per cent in the post-reform period. While the state withdrew from these sectors and did not undertake investment in infrastructure, the much-trumpeted claim that foreign private investment could boost infrastructure growth could not be realised in the post-reform period.

8.3.10 Economic Reforms and Reduction of Regional Disparities

Another important objective of development is to reduce regional disparities. Government has been helping the backward states with higher allocations so that regional disparities could be reduced.

But the reform process has been emphasising the use of market forces to attract investments. Experience reveals that the relatively developed regions are able to attract more resources – both economic and social – if markets are given a free play. The question of reducing regional disparities is sidelined. It would, therefore, be advisable to understand the impact of economic reforms on regional disparities among the states.

Data provided in Table 8.12 reveal that NSDP in forward states indicated a growth rate 6.0 per cent per annum during the period 1990-91 to 2000-01, but as against them, it grew in backward states at merely 1.4 per cent. This only underlined the fact that instead of reducing, it has further widened regional inequalities.

This can be observed by making a comparison of per capita NSDP. In case of Bihar, the per capita NSDP growth was negative to the extent of (-) 2.8 per cent during 1990-91 and 2000-01. In case of Uttar Pradesh, it was just 0.8 per cent. These two states account for 27 per cent of total population and thus, they pulled down the average all-India growth of per capita NSDP. If we compare the ratio of maximum and minimum NSDP, then it is revealed that this ratio was 2.7 in 1990-91 and increased to 4.6 in 2000-01. Obviously, the period of economic reforms has resulted in increasing regional disparities. This was due to the fact that approval of investment proposals and grant of financial assistance helped the forward states to further accelerate growth leaving behind the backward states which were not favoured by the market forces. Naturally, regional disparities in terms of growth of NSDP – both total and per capita – widened further.

Table 8.12: Statewise Net State Domestic Product and Per Capita NSDP (1990-91 to 2000-01) at 1993-94 Prices

(Rs. Crores) (Rs.)	Net State Domestic Product			Per Capita NSDP		
	1990-91	2000-01	Average Growth Rate (1990-91 to 2000-01)	1990-91	2000-01	Average Growth Rate (1990-91 to 2000-01)
Forward States			**6.0**			
1. Punjab	23,693	37,413	4.7	11,776	15,390	2.7
2. Haryana	18,215	28,655	4.6	11,125	14,331	2.6
3. Maharashtra	79,869	1,45,734	6.2	10,159	15,172	4.1
4. Gujarat	36,207	63,161	5.7	8,788	12,975	4.0
5. Tamil Nadu	43,937	79,121	6.0	7,864	12,779	5.0
6. Andhra Pradesh	45,131	75,868	5.3	6,873	9,982	3.4
7. Kerala	19,774	34,451	5.7	6,851	10,627	4.5
8. Karnataka	29,845	62,477	7.6	6,631	11,910	6.0
9. West Bengal	40,633	78,108	6.7	5,991	9,778	5.0
Backward States			**1.4**			
10. Rajasthan	29,713	44,335	4.1	6,760	7,937	1.7
11. Madhya Pradesh	41,833	41,530	-1.0	6,350	7,003	1.0
12. Assam	12,299	15,470	2.3	5,574	5,867	0.5
13. Uttar Pradesh	74,791	94,612	2.4	5,342	5,770	0.8
14. Bihar	37,607	27,383	-3.1	4,474	3,345	-2.8
15. Orissa	13,450	18,690	3.3	4,300	5,187	1.9
All India	**6,23,407**	**10,62,616**	**5.5**	**7,430**	**10,428**	**3.4**
Ratio between Maximum and Minimum Per Capita NSDP				2.7	4.6	

Note: States have been arranged in the descending order on the basis of per capita NSDP for 1990-91.

Source: Compiled and computed from Ministry of Finance (2003), *Indian Public Finance Statistics* (2002-03) and CSO, *National Accounts Statistics* (2003).

8.3.11 Economic Reforms and Human Development

Table 8.13 presents data on education and health indicators. Literacy rate is considered as a good indicator of human development in terms of education. For health, the indicators used are life expectancy, infant mortality, birth and death rates.

Table 8.13: Selected Indicators of Human Development for Major Status

	Literacy Rate (2001) (Per cent)			Life Expectancy at Birth 2001-06 (Years)		Infant Mortality Rate (2002)	Birth Rate (2002)	Death Rate (2002)
	Total	Male	Female	Male	Female			
Forward States								
Punjab	69.9	75.6	63.6	69.8	72.0	51	20.8	7.1
Maharashtra	77.1	86.0	68.1	66.8	69.8	45	20.3	7.3
Haryana	68.6	79.3	56.3	64.6	69.3	62	26.6	7.1
Gujarat	70.0	80.5	58.6	63.1	64.1	60	24.7	7.7
West Bengal	69.2	77.6	60.2	66.1	69.3	49	20.5	6.7
Karnataka	67.0	76.3	57.5	62.4	66.4	55	22.1	7.2
Kerala	90.9	94.2	87.9	71.7	75.0	10	16.9	6.4
Tamil Nadu	73.5	82.3	64.6	67.0	69.8	44	18.5	7.7
Andhra Pradesh	61.1	70.8	51.2	62.8	65.0	62	20.7	8.1
Backward States								
Madhya Pradesh	64.1	76.8	50.3	59.2	58.0	85	30.4	9.8
Assam	64.3	71.9	56.0	59.0	60.9	70	26.6	9.2
Uttar Pradesh	57.4	70.2	43.0	63.1	64.1	80	31.6	9.7
Rajasthan	61.0	76.5	44.3	62.1	62.8	78	30.6	7.7
Orissa	63.6	75.9	51.0	60.5	59.7	87	23.2	9.8
Bihar	47.5	60.3	33.6	65.7	64.8	61	30.9	7.9
All India	**65.4**	**76.0**	**54.3**	**63.9**	**66.9**	**63**	**25.0**	**8.1**

Source: Compiled from *Census of India* (2001) and *Economic Survey* (2004-05).

While it is possible to achieve higher levels of human development even with relatively lower levels of economic development as has been demonstrated by Kerala and Tamil Nadu, yet, by and large, better levels of per capita NSDP are associated with higher levels of human development in terms of education and health. For this purpose, it is necessary to step up investment in education and health infrastructure. Among the backward states Bihar, Uttar Pradesh and Rajasthan have very poor record in literacy, more especially female literacy. Even among the forward states – Haryana, Gujarat and Andhra Pradesh have a very poor record in female literacy.

Most of the backward states have poor record in health indicators like infant mortality, birth and death rates. It may be pointed out that among the forward states, Haryana indicates a poor record in terms of infant mortality and birth rates, though it enjoys a third rank in per capita NSDP. While Kerala and Tamil

Nadu represent cases where with a relatively lower level of economic development, a high level of human development has been achieved, Haryana is on the other extreme, where a high level of economic development has not succeeded in ushering higher levels of human development, although some progress has been achieved.

Check Your Progress 3

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Indicate the infrastructure industries in which economic reforms have failed to trigger higher growth rates.

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2) Have economic reforms failed to reduce regional inequalities? If so, why?

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3) Is the economic backwardness of a state necessarily linked with lower levels of human development? Support your answer by examples from the various states of India.

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8.4 LET US SUM UP

While economic reforms may be justified on the basis that they have helped to improve rate of growth of GDP, they cannot be justified in reducing unemployment and poverty to the desired extent. Their record in terms of increasing unemployment rates is too glaring. As far their impact on labour is concerned, it is adverse. They pushed labour from secure to insecure employment, increasing employers' militancy and weakened trade unions. A major sin of economic reforms is neglect of agriculture, more especially in terms of reducing investment in irrigation by the public sector. Economic reforms have also not been successful in accelerating industrial growth, more especially in electricity generation and mining. The failure was also manifest in basic and capital goods industries.

So far as Central Government Public Sector Undertakings are concerned, they have shown better record in terms of gross profits as well as net profits. It would, therefore, be advisable to grant them autonomy in decision-making so that they can improve their performance.

Regarding foreign trade, economic reforms have helped foreigners to penetrate the Indian market to a greater extent than Indians to penetrate foreign markets. This is evidenced by the continually growing trade deficit. However, in invisibles, India has been able to penetrate foreign markets, especially in software exports.

Economic reforms have succeeded in attracting foreign investment, more especially foreign direct investment, but not to the extent to which China has been able to.

Economic reforms have not succeeded in improving growth rates of infrastructure in electricity, coal and petroleum, though they have shown better record in saleable steel and cement.

Economic reforms have failed in reducing regional inequalities. Rather they are held guilty for increasing regional inequalities.

8.5 EXERCISES

1) The growth of employment in post-reform period has been unsatisfactory. Why?

2) What have been the effects of the reform process on the welfare of labour? Is the trend satisfactory from the point of view of human development?

3) Critics believe that the basic sin of economic reforms is neglect of agriculture. Do you agree?

4) Is there evidence of acceleration of industrial growth after undertaking wide-ranging industrial reforms? Support your answer with facts and figures.

5) The performance of Central Public Sector Undertakings has improved in the post-reform period. If this is so, is there a logic in continuing a policy of disinvestment?

8.6 KEY WORDS

Closure: The act or process of closing down a business.

Lay-off: Temporary or permanent discharge of workers, a redundancy.

Memorandum of Understanding: An agreement between the Government and a specific Public Sector Enterprise clearly specifying the intentions, obligations and mutual responsibilities of both the parties.

Trade Balance: The difference between the value of exports and imports of a country.

Balance of Payment on Current Account includes three items: (i) Visible trade relating to exports and imports; (ii) Invisible items, viz., receipts and payments for such services as shipping, banking, insurance, travel, software services etc. and (iii) Unilateral transfers such as donations.

UNIT 22 INDUSTRIAL POLICY IN INDIA

Structure

22.0 OBJECTIVES

After reading this unit, you will be able to:

- state the concept of industrial policy;
- appreciate the significance of industrial policy for economic growth in general and industrial growth in particular;
- identify features of the industrial policy that ushered in a controlled economy;
- explain why it became important to change the structure of the industrial policy from CIA (Controls, Indianisation and Abstinence) to LPG (Liberalisation, Privatisation and Globalisation); and
- know how and why it became imperative for the Indian economy to develop an environment in which the new industries could develop.

22.1 INTRODUCTION

The strategy of growth pursued in our Plans aimed at building the Indian economy in a self-reliant and self-sustained unit. Towards the achievement of this goal, the path of heavy-industry-led-growth was pursued. The policy environment, i.e., industrial and related policies relied on (i) import substitution, (ii) inward-oriented growth, and (iii) a system of controls and subsidies. Corresponding to the growth strategy and the industrial policy framework, public sector in India witnessed a phenomenal expansion; it came to acquire commanding heights of the economy. But soon it came to be afflicted with most of those ailments which are generally associated with a state-controlled system. A need was felt to make the public sector market-oriented. Hence, mid-stream corrections were decided and the policy got reformulated accordingly. In the new policy framework, public sector is being seen more in a supportive role. The initiative for growth is to come from the private capital and enterprise. The real transformation started after 1995, and was triggered by three factors. **One**, India began to see a host of relatively younger entrepreneurs who, unencumbered by protectionist baggage, were determined to prove their worth in a more competitive economy. **Two**, tariff rates started coming down even faster and quantitative import restrictions were becoming history — which increased the threat of imports. **Three**, MNCs began to enter India in greater numbers and created a milieu of global competition from within. Increasing privatisation of the economy is in harmony with the demands of liberalisation and globalisation policies.

22.2 CONCEPT OF INDUSTRIAL POLICY

There are several aspects of industrial policy which affect industrial investment and production.

- Industrial licensing policy which regulates the setting up of new (large and medium) industrial undertakings and their expansion.
- Policy concerning the control of monopolies and economic concentration – and the reservation of certain lines of production for the decentralised, small-scale sector – which in a way forms an integral part of industrial licensing policy.
- Policy regarding technology import. Closely allied to technology import policy is the policy regarding the import of capital goods, components and raw materials.
- A whole range of financial and fiscal policies which pertain to the provision of industrial finance, development of the capital market, as well as fiscal incentives/disincentives to investment and production.

It is in this background that we have to study the evolution of industrial policy in India, and see how far it has worked as a potent tool to realise the goal of planned development. Our attention would be focused on aspects of industrial policy other than fiscal and financial policies.

22.3 INDUSTRIAL POLICY IN INDIA

Till July 23, 1991, when the New Industrial Policy was announced by the Government, the industrial policy had been chalked out within the framework of the Industrial Policy Resolution, 1956 (IPR, 1956). The roots of the IPR, 1956,

can be traced back at least to a decade earlier. Immediately after Independence, it was considered desirable by the Government to announce its attitude towards private capital and to define the scope of State participation in economic activity. This aimed at removing all uncertainties that would have worked as constraints on industrial growth in the economy. This announcement took the form of the Industrial Policy Resolution, 1948 (IPR, 1948).

22.3.1 IPR 1956

A number of important developments had taken place in India since adoption of the IPR, 1948. These necessitated a fresh statement on industrial policy. Among these developments, the more important were as follows:

- New Constitution of India which guaranteed certain Fundamental Rights and provided for Directive Principles of State Policy;
- Completion of the First Five-Year Plan and the commencement of the Second Plan; and
- Acceptance by Parliament of the socialist pattern of society as the objective of social and economic policy.

The industrial policy, as other policies, was, therefore, to be governed by these principles and directions. The IPR, 1956, has been known as the 'Economic Constitution' of India. The Resolution put emphasis on:

- the development of heavy and machine-building industries;
- the expansion of the public sector;
- the establishment of a large and growing co-operative sector; and
- encouragement to the diffusion of ownership and management in the private sector.

Besides reiterating the already-declared goals of promoting cottage and small-industries, maintenance of industrial peace, reduction in regional disparities and the need for establishing proper managerial and technical cadres, the most distinguishing feature of the IPR, 1956, was the classification of the entire industrial sector in three schedules as follows:

- Schedule A which contained 17 industries — all new units in these industries, where their establishment in the private sector has already been approved, would be set up only by the State.
- Schedule B contained 12 industries. Such industries would be progressively state-owned, but private enterprise is expected to supplement the efforts of the State in these fields.
- Schedule C industries, the future development of these industries had been left to the initiative and enterprise of the private sector.

However, notwithstanding this demarcation, it was always open to the State to undertake any type of industrial production.

23.3.2 New Industrial Policy, 1991

Making a sharp departure from the Industrial Policy Resolution, 1956, the Government announced a new industrial policy on July 24, 1991. The basic philosophy of the new policy has been summed up as: 'continuity with change'.

Objectives

- To consolidate the strengths built up during the first four decades of economic planning and to build on the gains already made;
- To correct the distortions or weaknesses that may have crept in the industrial structure as it had developed over the first four decades;
- To maintain a sustained growth in the productivity and gainful employment; and
- To attain international competitiveness. The pursuit of these objectives will be tempered by (a) the need to preserve the environment, and (b) the need to ensure the efficient use of available resources.

Policy Changes: Important changes in the NIP 1991, including the subsequent changes, can be recounted as follows:

Industrial Licensing Policy

- Industrial licensing has been abolished for all projects except for a short list of industries[1] related to security and strategic concerns, social reasons, hazardous chemicals and overriding environmental reasons, and items of elitist consumption.
- Only three industries groups where security and strategic concerns predominate will be reserved exclusively for the public sector.[2]
- In projects where imported capital goods are required, automatic clearance will be given in the following cases:
  - — where foreign exchange availability is ensured through foreign equity,
  - — if the CIF value of imported capital goods required is less than 25 per cent of the total value of plant and equipment, up to a maximum value of Rs.2 crore.
- There is no requirement of obtaining industrial approvals from the Central Government (except for industries under compulsory licensing) for location not falling within 25 kms. of cities having population of more than one million.
- Industries of non-polluting nature such as electronics, computer software and printing can be located within 25 kms. of the periphery of cities with more than one million population. Other industries are permitted only if they are located in designated industrial areas.

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[1] Only five industry groups as follows, presently, are subject to industrial licensing:
- Distillation and brewing of alcoholic drinks
- Cigars and cigarettes of tobacco and manufactured tobacco substitutes
- Electronic aerospace and defence equipment: all types including arms and ammunition and allied items of defence equipment, defence aircraft and warships
- Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches
- Hazardous chemicals
- Drugs and pharmaceuticals (bulk drugs industry has been delicensed)

[2] Three industry groups are:
- Atomic energy
- Substances notified by the Department of Atomic Energy
- Railway transport (private capital is being allowed limited entry in railway transport)

- The mandatory convertibility clause will no longer be applicable for term loans from the financial institutions for new projects.
- All existing registration schemes will be abolished.
- Entrepreneurs will henceforth only be required to file an information memorandum on new projects and substantial expansion.
- The system of phased manufacturing programmes run on an administrative case-by-case basis will not be applicable to new projects.
- The exemption from licensing will apply to all substantial expansions of existing units.

Foreign Investment

- Automatic approval is available to FDI in almost all sectors except a few sensitive ones. Automatic approval is available for 50 per cent, 51 per cent, 74 per cent and even 100 per cent in specified industry groups.
- To provide access to international markets, majority foreign equity holding up to 51 per cent equity will be allowed for trading companies primarily engaged in export activities.
- The Foreign Investment Promotion Board has been constituted to negotiate with a number of large international firms and approve direct foreign investment in select areas.

Foreign Technology Agreements

- Automatic permission will be given for foreign technology agreements in identified high priority industries up to a lumpsum payment of $ 2 million, 5 per cent royalty for domestic sales and 8 per cent for exports, subject to total payments of 8 per cent of sales over a 10-year period from date of agreement or 7 years from commencement of production.
- In respect of industries other than those included above, automatic permission will be given subject to the same guidelines as if no foreign exchange is required for any payments.

Public Sector

- Portfolio of public sector investments will be reviewed with a view to focus the public sector on strategic, high-tech and essential infrastructure. Whereas some reservation for the public sector is being retained, there would be no bar for areas of exclusivity to be opened up to the private sector selectively. Similarly, the public sector will also be allowed entry in areas not reserved for it.
- Public enterprises which are chronically sick and which are unlikely to be turned around will, for the formulation of revival/rehabilitation schemes, be referred to the Board of Industrial and Financial Reconstruction.
- In order to raise resources and encourage wider public participation, a part of the government's share holding in the public sector would be offered to mutual funds, financial institutions, general public and workers.

MRTP Act

- The MRTP Act was amended to remove the threshold limits of assets in respect of MRTP Companies and dominant undertakings.
- Provisions relating to restrictions with regard to prior approval of the Central government for establishing a new undertaking, expanding an existing undertaking, amalgamations, mergers etc., have been deleted.
- Emphasis will be placed on controlling and regulating monopolistic, restrictive and unfair trade practices.

The new policy overnight altered the industrial scenario in India. In intent and scope, the industrial policy is a watershed which will be as significant for the economy as the IPR, 1956 which gave primacy to the role of the State in industrial development. Henceforth, industrial enterprise, efficiency and the market will be the determinants of industrial advancement.

Check Your Progress 1

1) State in brief the main features of the Industrial Policy Resolution, 1956.

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2) State in brief the objectives of the New Industrial Policy, 1991.

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3) Name the industry groups that are subject to industrial licensing presently.

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22.4 INDUSTRIAL LICENSING IN INDIA

The system of industrial licensing was adopted in India to give effect to the IPR, 1948. Since then the system has continued to operate, and modifications have been introduced in it from time to time. It will be helpful to review the growth of this system before we could make an overall assessment of the State policy in regard to industry, what its failures have been and how could these be removed in the democratic framework of a mixed economy.

22.4.1 Systems and Objectives of Licensing

An industrial licence is an important instrument of State policy. A licence is a written permission from the Government to an industrial unit to manufacture goods specified in the permission letter. A licence to run an industry also specifies such particulars as the location of the plant, goods to be produced, the capacity of the unit, period within which the industrial capacity is to be established, etc.

The prime objective of the licensing system is to give effect to the industrial policy of the Government; apparently, the broad objectives of the system will have to be in consonance with those laid in the industrial policy. Any structural change in industrial policy will call for a corresponding change in the objectives of industrial licensing.

22.4.2 Legislative Framework

The legislative framework of industrial licensing is embodied in three different Acts passed at different time.

A. INDUSTRIES (DEVELOPMENT AND REGULATION) ACT, 1951

The industries (Development and Regulation) Act (in short, known as the IDRA) was passed in October, 1951. It came into force on May 8, 1952.

1) **Objects:** The chief object of the Act, as its title shows, is the development and regulation of Indian industries in a manner befitting the policy, planning, socialistic society, and other social, economic or political considerations.

2) **Provisions:** The Act makes the registration of all industrial units in the scheduled industries compulsory and enjoins upon the owners thereof to obtain a certificate of registration within a prescribed time. It also requires the new industrial units to be established only after obtaining a licence from the Central Government. A licence from the Government is required for any of the following purposes: (a) starting of a new industrial unit, (b) a substantial expansion of the existing unit, (c) the manufacture of a new 'article' and (d) shifting the location of an industrial unit.

3) **Scope:** The Act in its original form applied to industries included in the first schedule to the Act. The schedule covered a number of industries like metallurgical, industrial machinery, transportation, fertilizers, textiles, cement, defence, etc.

The NIP has made a virtual bonfire of this Act. The new policy has abolished industrial licensing for all projects, except for 6 specific groups which will continue to be subject to compulsory licensing for reasons related to safety and overriding environmental issues, and manufacture of products of hazardous nature.

The industries still subject to licensing account for less then 10 per cent of value added in the manufacturing sector.

B. COMPETITION ACT, 2002

The Mahalanobis Committee, in 1960 brought out the issue of growing inequalities in the post-independence period. The Monopoly Inquiry Commission (MIC) in its Report submitted in 1965 recognised the ill effects of concentration of economic power. The findings of MIC prompted the Government of India to enact the Monopolies and Restrictive Trade Practices Act (MRTPA), 1969 which came into

force on June 1, 1970 with the objective of prevention of concentration of economic power to the common detriment, control of restrictive trade practices. The Act covered monopolistic trade practices and restrictive trade practice. Unfair trade practice was added through amendment in 1984.

The issue of concentration of economic power was addressed by the government by making it obligatory for undertakings with assets of the total value of Rs.20 crore or more (later raised to Rs.100 crore or more in 1985 and removed altogether in 1991) and for dominant undertakings which enjoy 1/4th of the market share of the total market (which was initially 1/3rd) with assets of Rs. one crore or more, to seek prior approval before effecting expansion of the undertaking.

As the economic reform programme got implemented in the 1990s, it became more and more evident that the MRTPA was not in sync with the policies under the reform programme. An imperative need was felt to shift the focus from curbing monopolies to promoting competition. The Raghavan Committee in its report observed that MRTPA was limited in its sweep. On the recommendation of this committee, the Competition Act, 2002 was enacted.

The Act is "to provide, keeping in view the economic development of the country, for the establishment of a Commission to prevent practices having adverse effects on competition (AAEC); to promote and sustain competition in markets, to protect the interest of consumers, and to ensure freedom of trade carried on by other participants in markets, in India."

Even though the Competition Act, 2002 was enacted on January 13, 2003, its enforcement was delayed because of certain legal issues raised in courts of law. The Act was amended by Competition (Amendment) Act, 2007 to address the issues raised.

The Act covers (1) anti-competitive agreements, (2) abuse of dominant position, (3) anti-competitive combinations, and (4) competition of advocacy.

1) **Anti-competitive Agreements:** The Act prohibits anti-competitive agreements among enterprises. The Act is pro-competitive and it exempts efficiency enhancing joint ventures from the purview of 'presumption' of appreciable adverse effect on competition. In such cases, rule of reason test would suffice.

   While determining whether an agreement has anti-competitive provisions, the Commission shall have due regard for any or all of the following factors: (i) creation of barriers to new entrants in the market; (ii) driving existing competitors our of the market; (iii) foreclosure of competition by hindering entry into the market; (iv) accrual of benefits to the consumers; (v) improvements in production or distribution of goods or services; and (vi) promotion of technical, scientific and economic development by means of production or provision of services. Of these the first three [(i)-(iii)] may have effects of an adverse nature on competition and the last three [(iv)-(vi)] have effect of a beneficial nature.

2) **Issue of Dominance:** Dominance is defined in the Act as a position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to: (i) operate independently of competitive forces prevailing in relevant market; or (ii) affect its competitors or consumers or the relevant market in its favour. Dominance as such is not frowned upon. Its abusive exercise is what is prohibited.

3) **Regulation of Combinations:** Combination, under the Act, is a broad term covering mergers, a malgamations, acquisitions and acquiring of controls, between enterprises where the combined assets or turnover are above specified threshold levels. The Act empowers the Commission to evaluate the effect of mergers on competition in the relevant market in India. In case any merger is likely to have appreciable adverse effect on competition, the Commission may order de-merger which may have both cost to the merged entities and might also involve social costs in terms of displacement of workforce, reworking business strategies, etc.

4) **Competition Advocacy:** Competition advocacy is one of the salient features of the Act. The Commission is obliged to take suitable measures for the promotion of competition advocacy, creating awareness and imparting training about competition issues.

Competition Act, 2002 and MRTP Act, 1969: A Comparison

Although MRTP Act, 1969 has been repealed, yet is worthwhile to note the comparison between the two:

1) CA 2002 is a break from the philosophy which governed MRTPA. While the latter law generally treated structure as deemed to be bad and concentrated on curbing monopolistic and restrictive trade practices, the former emphasises promotion of competition. Under CA 2002, four types of horizontal agreements are presumed to have 'appreciable adverse effect on competition', all other types of agreements, both horizontal and vertical, and combinations would be subjected to 'rule of reason'. Only in five types of conduct specified in the Act, if engaged in by dominant enterprises, are deemed to be anti-competitive.

2) MRTPA focussed on size and structure, especially until 1991, while CA 2002 focusses on effects on competition in Indian markets. Even as the limited role of MRTPA related to regulation of mergers was taken away in 1991, there is a comprehensive merger regulation under CA 2002.

3) There are also divergences between the two laws as regards extra territorial jurisdiction, powers of investigation, penalty, advocacy role, treatment of intellectual property rights, concept of relevant market, coverage of the Act, autonomy of the Commission, etc.

C. FOREIGN EXCHANGE MANAGEMENT ACT

The Foreign Exchange Management Act (FEMA) replaces its immediate predecessor, the Foreign Exchange Regulation Act, 1973 (FERA, 1973). FERA – often described as the economic canvas of the country – had its origin in the Foreign Exchange Regulation Act, 1947 (FERA, 1947).

The FERA, 1973 was formulated in the background of a highly restrictive and centrally controlled industrial policy regime. The subsequent amendment to the FERA in 1993 substantially diluted its regulatory provisions and brought it in line with the new liberalised industrial, trade and exchange rate policies. The FERA has since been repealed and replaced by FEMA.

Along with FEMA a law to prevent money laundering has also been enacted. This is known as the Prevention of Money Laundering Act, 2002. The Act defines the offence of money laundering as any activity connected with the 'proceeds of crime' which in turn is defined as any property or value of such property derived as a result of any criminal activity.

The FEMA has come into operation from June 1, 2000.

Aim

The FEMA 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 markets."

Provisions

1) Current account transactions were permitted freely subject to a few restrictions:

   a) Certain current account transactions would require RBI permission if they exceed a certain ceiling;

   b) A few current account transactions need permission of appropriate Government of India authority irrespective of the amount; and

   c) There are seven types of current account transactions which are totally prohibited and no transaction can, therefore, be undertaken relating to them. These include transactions relating to lotteries, football pools, banned magazines and a few others.

2) The Act gives full freedom to a person resident in India who was earlier resident outside India to hold or own or transfer any foreign security acquired when she / he was resident there.

3) A person resident outside India is permitted to hold shares, securities and properties acquired by him while he/she was resident in India.

4) The exchange drawn can be used for purpose other than for which it is drawn provided drawal of exchange is otherwise permitted for such purpose.

5) The Exchange Earner's Foreign Currency (EEFC) account holders and Resident's Foreign Exchange (RFE) account holders are permitted to freely use the funds held in EEFC/ RFC accounts for payment of all permissible current account transactions.

6) The rules for foreign investment in India and Indian investment abroad are also comprehensive transparent and permit companies engaged in certain specified sectors to acquire shares of foreign companies engaged in similar activities by share swap or exchange through issue of ADRs/ GDRs up to certain specified limits.

FEMA is a civil law unlike FERA. Unlike in FERA, the burden of proof under FEMA will be on the enforcement agency and not on the accused.

OTHER CONTROLS

Capital Issues Control: The Companies are free to issue new equity or debentures either at par or on premium. The Securities and Exchange Board of India, set up under the SEBI Act, 1992 has been extended statutory powers entrusting it with the task of ensuring disclosures and investor protection. For this purpose, SEBI has issued a set of comprehensive guidelines which provide among other things for the following:

a) a new company with no previous trade record can issue capital to public only at par;

b) a new company promoted by promoters with a good track record for a least

five years and with promoters' contribution of not less than 50 per cent to the equity can freely price issues;

c) the private and closely held companies shall be permitted to price their issues freely if they have had consistent profitability for at least three years.

The Securities Contracts (Regulation) Act, 1956: The Act provides for, apart from regulation of stock exchanges, a general system and apparatus of control to ensure fair dealing in securities and protecting investors. In terms of recent amendment to this Act, companies cannot reject, except on technical grounds, share transfer without appropriate reference to the Company Law Board.

Import and Export Control: Import and export control in India is exercised under the provisions of the Foreign Trade (Regulation and Development) Act, 1992, which succeeds the Imports and Exports (Control) Act, 1947. The principal objective of the Act is 'to provide for the development and regulation of foreign trade by facilitating imports into, and augmenting exports from India.

Commodity Control: Commodity control in India is exercised under the provisions of the various Acts enacted by the Government. The first in the list is the Essential Commodities Act, 1955, which empowers the Central Government to control, regulate or prohibit the production, distribution, transport, trade, consumption or storage of a large number of commodities, to prescribe their prices and even to take over stocks on conditions it itself sets.

— for controlling the prices at which such an article shall be purchased and sold;

— for regulating by licences, the distribution, transport, etc. of such articles;

— for prohibiting any person to withhold from sale of an article ordinarily kept for sale;

— for requiring producers of any such articles to sell the whole or a part of their stocks;

— for regulating such articles as are detrimental to public interest;

— for requiring the sellers to exhibit price list, etc; and

— for collecting information and statistics and the like.

Besides, there are a number of enactments to control various specific commodities like coffee, coir, tea, rubber, sugar, etc.

1) The Coffee Act, 1982, established the Coffee Board empowering it to fix quotas for internal sale, exports, etc.

2) The Coir Industry Act, 1983, takes the coir industry under the Central control.

The Coir Board is appointed to promote the development of the coir industry to take measures to promote exports of the coir products.

1) The Tea Act, 1953 brings the tea industry under the Central control and creates the Tea Board on the lines of the Coir Board.

2) The Rubber Act, 1947, constitutes the Rubber Board to promote development of the rubber industry.

3) The Sugar (Regulation of Production) Act, 1961, controls the production and distribution of sugar.

Financial and Credit Controls: Allocation of credit is subject to guidelines or policy announced by the government from time to time. A large part of government exercises formal and informal control over the allocation of financial resources.

Location, Environment and Labour Legislation: The location of industries is banned in the municipal areas of all towns and cities, as well as in specific areas around the largest twenty cities. Environmental and pollution control clearance for all projects above a certain size is also mandatory. The rules regarding closure of units, retrenchment of labour, compensation, and sale of assets of a sick unit are governed by a comprehensive set of labour laws.

To top all these controls is the Companies' Act, which, in its present incarnation, has 658 sections and hundreds of sub-sections, clauses, sub-clauses and amendments governing every aspect of the running of a company, from audits and printing of annual reports, to remuneration of directors, and investments and mergers.

22.4.3 Review of Industrial Licensing in India

Industrial licensing was introduced in India with the IPR, 1948. The system worked to provide protection to Indian industry.

Protection, both against potential domestic competition and foreign competition, was the right approach in the initial stage of industrialisation in a developing economy which was struggling to come out of the stranglehold posed by two-centuries old colonial domination. The industrial landscape underwent a dramatic change within a period of about four decades. But the major failure of the policy of protection was that it did not have a built-in mechanism that could prompt the industry to adapt itself to the fast-changing technological scene to which a large part of the underdeveloped world was responding with zeal and enthusiasm. The industrial structure of India, under the burden of protection, turned out to be high-cost and low-quality that lacked the basic ingredients of international competitiveness. Instead of fortifying the economy (where domestic economy will be protected against outright incursions), we made a 'jail' out of it. The tiger was 'caged' and remained so for long, its muscles became frigid and lacked in flexibility.

It was becoming increasingly clear that the industrial policy would have to be taken out of the "Convoluted Cobweb" in which it had got landed, system of controls would have to be gradually given up and the industrial economy liberalised, so as to enable it to breathe some fresh air.

22.5 PHASE OF LIBERALISATION

Mid-1970s Onwards

Experiments with domestic liberalisation began in the mid-1970s. In 1975, a scheme was introduced which provided for an increase in licensed capacity up to a maximum of 25 per cent in a five-year period. Other measures included regularisation of capacities in excess of authorised capacities for Appendix-I industries, some liberalisation from controls for units which exported 100 per cent of their production, and a more general scheme of re-endorsement of capacities introduced in 1982. The exemption limit for industrial licensing was also raised from Rs. 1 crore as set in 1970 to Rs. 3 crore in 1978 and to Rs. 5 crore in 1983,

and further to Rs. 25 crores for those units that were set up in the non-backward areas and to Rs. 75 crores for those units that were set up in the backward areas since June 1988.

The main emphasis during the 1970s was on reducing the restrictive and complex features of the licensing policy.

Mid-1980s Onwards

The process of reorientation of industrial policy gathered momentum after mid-1980s. The Government set up several committees to examine its fiscal, monetary, industrial and trade policies. The general outcome of their findings and recommendations can perhaps be simply expressed in two sets of interrelated propositions.

Requirements for Accelerated Growth

a) Accelerated growth will require increased imports.

b) Owing to decreases in concessional aid and risks of onerous debt burdens connected with large-scale commercial borrowing, it is absolutely necessary to increase exports to pay for increased imports.

c) To increase exports it is necessary to enhance the competitive advantage of exportables; requires changes in industrial, trade and fiscal policies.

Domestic Resources Situation

a) The Government budget is no longer a source of finance for investment.

b) Reducing defence expenditure is not an option available to the Government.

c) Subsidies can be reduced only gradually to avoid major social and political upsets.

d) The only way to raise additional resources is to make the tax system more responsive and to make the public sector enterprises generate resources through greater efficiency.

In view of these, period beginning with 1985 saw the development of rule based industrial policies like dual prices, tax and tariff based interventions rather than direct price, output or capacity controls at the level of the firm. Concepts like broadbanding, minimum economic capacity, delicensing, etc. made their appearance during this period. The role of market and importance of private incentives came to be appreciated.

July 1991 Changes

The process of liberalisation got a fillip with the announcement of the New Industrial Policy (NIP) in July 1991, and entered a new phase of what has been described as ‘reform by storm’ that supplants ‘reform by stealth’ of the last half of the 1970s, and ‘reform with reluctance’ during the second half of the 1980s.

1) As already stated earlier, the NIP has made a bonfire of the industrial licensing system through various provisions. There has also been some move away from extensive physical controls and an increase in the role of financial incentives in channelling investments in the desired areas. This, plus the lowering of the tax rates combined with better administration of the revenue-collecting system,

should help in attracting a lot from the mainstream back into the fold. The role of the financial institutions becomes very important in the new regime.

2) There is considerable internal deregulation aimed at strengthening the more efficient domestic firms and encouraging them to invest and expand. This is expected to inject much more competition into the system, creating incentives for reducing costs. Scientists tell us that the diamond sparkles because of a phenomenon called total internal reflection. If our economy is to sparkle, total internal liberalisation is the key.

3) Measures have also been taken to improve the legal framework.

   - The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 gives powers to banks and financial institutions to enforce their claims on collateral for delinquent secured credit, without going through a long and cumbersome judicial process.
   - Companies (Amendment) Act, 2002, will enhance the competitiveness of co-operatives, and enable them to compete and operate in today's liberalised, globalised market.
   - In Companies (Second Amendment) Act, 2002, industrial sickness has been redefined; a revival and rehabilitation fund has been set up; protection from creditors has been withdrawn.
   - The Competition Act, 2002 aims at promoting competition through prohibition of anti-competitive practices, abuse of dominance and through regulation of companies beyond a particular size.
   - DIN (Director Identification Number) have been issued to all the directors of all the companies under a surveillance system. The system will give the government instant access to the details and nature of employment relevant to company law requirements and antecedents which are crucial to investor protection.

4) The internal liberalisation has been accompanied by a policy of maintaining an open access to imports to permit modernisation and technological upgrading in Indian industry which again will reduce costs and promote international competition.

   An important feature of the process of policy reform under way in India is that it is gradualist, as against the 'big bang' type adopted in countries like Mexico. The system is being subjected to much stronger pressures for efficiency and moderanisation, but at a controlled pace. The rationale for this gradualist approach lies in the perception that the system should be subjected to pressure commensurate with its ability to respond. Pressure beyond this point is only disruptive. But, then, we must also note that liberalisation is like pregnancy; one has to impregnate fully to get results.

Aims: The aim of recent sweeping policy changes is to evolve an integrated economic package that can be implemented in stages to create an appropriate environment so as to encourage and promote greater efficiency, higher productivity and faster industrial growth in desired directions through a well-coordinated system of incentives. Accelerated growth of manufacturing, accompanied by radical restructuring and induction of 'sunrise' industries within a suitably modified policy frame would bring about a significant transformation of India's industrial economy.

22.5.1 New Industrial Policy 1991, and Public Sector

New Industrial Policy, 1991, heralds a new approach to public enterprises. It seeks to restrict the role of public sector to provision of physical and social infrastructures and to areas where security and strategic considerations predominate. It favours 'distancing' public enterprises from Governments and, creating an environment for 'mimicing' competitive markets. It suggests that unless it is necessary for protecting the interests of poorest in the society the principle of market economy should be accepted as the main operative principle.

The four major principles which have guided the new policy framework can be briefly stated as follows:

1) Partial disinvestment of equity of PSUs as first step in the commercialisation of enterprises and in making them subject to open public scrutiny.

2) PSUs to be encouraged to raise fresh equity directly from the public rather than from the government. If carried to its logical conclusion the future expansion of enterprises would depend on their ability to attract capital from the public, which, in turn, would depend on their financial performance.

3) Public sector monopolies need to be subjected to competition from new private enterprises in most sectors. A competitive environment is a necessary, though not a sufficient condition for the use of resources by enterprises.

4) Steps to be taken to make institutional relationships between the government and the PSUs contractual and less *ad hoc*.

The different policy announcements with regard to the above can be briefly recounted as follows:

i) Exclusive reservation for public sector has been reduced only to two industry groups: railway transportation and atomic energy. Even in the reserved industries, private investment is to be considered selectively on a case to case basis.

ii) The priority areas for growth of public enterprises in future will be the following:

   — essential infrastructure goods and services,

   — exploration and exploitation of oil and mineral resources,

   — technology development and building of manufacturing capabilities in areas which are crucial in the long-term development of the economy and where private sector investment is inadequate, and

   — manufacture of products where strategic considerations predominate such as defence equipment.

iii) Government will review the existing portfolio of public investments with greater realism. This review will be in respect of industries based on low technology, small-scale and non-strategic areas, inefficient and unproductive areas, areas with low or nil social considerations or public purpose, and areas where the private sector has developed sufficient expertise and resources.

iv) Steps have been taken towards a market orientation of public enterprises with a view to making these units behave competitively. Corporatisation is an important step, seeking to create institutions that operate as separate entities,

adopting a commercial approach in their activities. An important example of this is in the telecom sector.

v) Public enterprises which are chronically sick and which are unlikely to turn around will, for the formulation of revival/ rehabilitation schemes, be referred to the Board for Industrial and Financial Reconstruction, or other similar high-level institutions created for the purpose.

vi) Budgetary support in the form of non-plan loans to loss-making PSUs is being phased out, i.e., PSU managements are being asked either to 'shape up or ship out'.

vii) Boards of public sector companies would be made more professional (1/3rd outside directors and government nominee directors restricted to 1/6th or maximum 2) and given greater powers. As an illustration, now no permission is required from the Public Investment Board if PSUs wish to invest upto Rs.50 crore in a joint venture. However, this rule will apply only to the healthy PSUs, i.e., those units which (i) do not depend on the budget, (ii) have not defaulted on loan repayments, and (iii) have made net profits for the last three years.

viii) There will be greater thrust on performance improvement through the Memoranda of Undertaking (MOU) system[3] through which managements would be granted greater autonomy and will be held accountable.

ix) PSUs have been given greater autonomy and powers to decide on mergers and acquisitions; this will enable them to vertically integrate and move up the value chain so as to maximise returns.

22.5.2 Policy Towards Small-Scale Industry

India has the longest history of small enterprise development policy in Asia. Over the last six decades, India has built up perhaps one of the world's most elaborate small enterprise development programmes for providing assistance to individuals and institutions for setting up small-scale enterprises, both in the urban and rural areas. In the post-reforms period there has been a shift in focus from 'protection' to 'promotion'.

The future growth of SSIs under a liberalised regime is constrained by a number of factors, among which the more important are: (i) change in consumer preference, (ii) outmoded technology, (iii) uneconomic scales of operation, (iv) lack of organisation, (v) total disregard of environment standards, and (vi) high incidence of sickness. In a partial response to this situation, the government announced on August 6, 1991, a joint package of policy measures for small, tiny, handloom, handicraft and village industries.

Features of the New Policy

Unlike in the past, the policy does not contain mere intentions of Government. It

[3] However, the MOU system has already come in for severe criticism. A World Bank study dumps the system "as ineffective in improving the return on assets, labour productivity and total factor productivity" of the companies. In view of these criticisms, a two way thrust is proposed to be given to further fine tune the system. One, the accent is on giving clear targets to the management of PSUs and ensure greater focus on financial efficiency and fiscal discipline in the MOUs by giving 60 per cent weight to MOU performance. Two, assigning 75 per cent weight to MOU performance in the annual confidential reports of the PSU chiefs.

has proposed clear guidelines to deal with the three major areas of concern for the sector: (1) finance, (2) marketing, and (3) technology (Table 22.1)

Table 22.1: New Small Scale Industrial Policy, 1991: Major Thrust Areas.

S. No.	Major Features	Objectives
1.	Emphasis to shift from subsidies/cheap credit to adequate credit	To meet the emerging demand for credit
2.	Equity participation by other undertakings domestic/foreign	
3.	Introduction of factoring services through banks	To strengthen small industry marketing
4.	Marketing of mass consumption goods under common brand name	
5.	Industry associations to be involved in setting up sub-contracting Exchanges (SCXs)	
6.	Technology Development Cell in Small Industry Development Organisations (SIDO)	To upgrade technology and promote modernisation
7.	Industry association to establish quality counseling and common testing facilities	
8.	Technology Information Centres and TBSE	
9.	Reoriented modernisation and technology upgradation programmes-cluster-based approach	

The problems of small industry in these areas are closely interlinked. It is due to rather 'insufficient' quality that small industry units face the problem of marketing. To improve quality, many of these require to go for technology upgradation and modernisation. This, in turn, demands enormous amount of funds. Even after modernisation, to sustain competitiveness, small industry should have access to technology information.

It pursuance to this policy, a comprehensive new policy package for small-scale industry was announced in March 1994, supplemented by a set of policy initiatives announced in June 1998 and August 2000, based largely on the recommendations of S.P. Gupta Committee and other inputs from various sources.

It aims at giving SSIs a level playing field vis-à-vis large and medium sector in respect of availability of raw materials, credit and infrastructure facilities. The package will provide faster mechanism for review of list of items reserved for SSIs keeping in view the changing situation. It will also facilitate integration of the SSIs with other sectors, accelerate modernisation and technology upgradation and relieve the sector of the harassment of Inspector Raj by abolishing 50 per cent posts of inspectors.

22.5.3 Industrial Policy and Balanced Regional Development

One of the prominent objectives of planned economic growth, and its adjunct industrial policy, right since beginning has been to promote balanced regional development. Historically, location pattern of industrial growth in the past had been influenced by the early pattern of railway construction. These centers of

industrial location, therefore, in conformity with Gunnar Myradal's thesis, have attracted a considerable portion of industrialisation towards themselves because of conglomeration economics.

This also influenced the development of infrastructure. The better-developed regions are having inbuilt infrastructure dating back to the time when they were still princely states. In other regions, the princely states did not pay much attention to the development, priding themselves on being messengers of God or something believing they were born to rule.

Further, the developed states have had relatively more efficient systems of governance in terms of skills, responsiveness and quality or delivery system. Unlike capital – which is highly mobile across regions and continents – good governance cannot be transplanted in an area, as it evolves basically with the prevailing socio-political structure over a long period. An outmoded social structure can never bring about or sustain good governance in the modern sense. On the contrary, it can frustrate exogenous attempts at good governance by its debilitating and corrupting influence.

Overshadowing all these has been the recent philosophy of growth, viz. globalisation. Because of growing integration of the economy with rest-of-the-world, Indians have chosen a skill-intensive path to growth; wages for skilled labour are already being bid up. In this situation, it is necessary for firms to ensure the proper use of scarce skilled labour. But it is only in the fast-growing state that the environment and infrastructure exist for scale. This further promotes disparities. In addition, the economic reforms provided greater freedom and impetus to the private sector and export-oriented production. The sectors which were attempting to reduce costs and become competitive, were attracted to more developed areas. As a result, investment and activity shifted to these areas, strengthening the process of divergence.

In this changing environment, neither the plan strategy nor the industrial policy had much space to work for and seek balanced regional development. The objective of balanced growth can be seriously pursued only if we were ready to comprise with growth rate.

Check Your Progress 2

1) State in brief the objectives of the industrial licensing system in India.

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2) State in brief the provisions of the industrial licensing system in India.

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3) Mention in brief the main features of the Competition Act, 2002.

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22.6 IMPACT OF POLICY CHANGES

Although it is too early to evaluate the impact of these policy changes, it can nevertheless be established that the industrial climate is in for a change.

22.6.1 Positive Effects

India has woken up to the liberating influence of what Joseph Schumpeter called "creative destruction" — the death of the outdated at the hands of the modern. We may note the following trends in the post-liberalisation phase:

1) The post-liberalisation era has propelled companies into a restructuring spree; companies are doing away with their not-so-profitable businesses. Corporate sell-offs are moving at a pace never seen before. Reasons are many:

   — Downsizing or 'right sizing' to take the sting out of it. Corporates are using downsizing as a business tool and linking productivity to profitability.

   — The FIs have turned activists, and are forcing out the incompetent managements.

   — Indian corporates have got over the emotional trauma of selling a company. Sale of a company is no longer an admission of failure but an example of vision.

2) More ambitious players have been consolidating themselves by way of mergers and acquisitions. Entrepreneurs have come to believe: "In business, big is always beautiful."

   Mergers succeed

   — by boosting profits through elimination of overlapping activities;

   — by generating savings from post-merger economies of scale;

   — by increasing borrowing opportunities through improved gearing;

   — by paving the way for raising equity through more attractive financial ratios;

   — they offer tax-breaks where one merging company is making profits;

   — by offering the possibility of raising equity holdings to ward off take overs;

   — by improving market capitalisation and helping boost share prices.

   However, mergers fall when

   — the merged company becomes too big to be managed efficiently;

— contradictory compulsions make the company lose its focus;

— companies in diverse businesses are merged for financial gains;

— there is no cultural fit between the organisations being merged;

— the profits of one company are used to subsidise the other's losses;

— the one-off gains of the merger are not available in subsequent years;

— productivity levels at the merging companies are widely unequal;

— workers of one company start demanding the benefits of the other.

— To facilitate mergers and acquisitions government is promoting single-window forum on the lines of the J.J. Irani Committee's recommendations.

3) Over the last two decades, Indian manufacturing companies have emerged at par with the best in the world from the quality perspective, and the next steps will take them to the next stage. The graph indicates the progress made by the automotive industry.

This has happened because Indian manufacturing has adopted world-class practices in manufacturing management by educating their employees, both managers and shop-floor staff with the help of global teachers, mainly Japanese, who have brought in the best manufacturing management techniques. These practices have shown positive results in bringing down customer returns to below 50 parts per million (ppm), and have reduced manufacturing costs by 15-20 per cent over the decade.

By focusing on quality, costs have been reduced by eliminating waste (*muda*, the Japanese word), which is the mantra of all manufacturing in India today.

4) India's share in world market capitalisation is now more aligned with its share in global GDP. Future increase in market cap will have to depend on a breakthrough in economic growth.

5) Economic reforms have created an environment conducive for low-cost innovation. This, combined with increasing pressures for inclusiveness, will contribute to creating an income-faster than earlier forecast. By 2015, the largest number of households will fall in the middle-income slabs. That is creating a huge mass market for goods and services at a price affordable for this segment. Consequently, India is increasingly becoming a center for low-cost innovation and new business models.

6) Indian business have emerged leaner, more efficient in terms of process, quality and financing, and competitive on a global scale. Companies have learnt the critical importance of operating discipline, financial discipline and efficiency. They have changed their mindsets, cleaned up their shop floors, restructured their balance sheets and improved their products in terms of functionality and quality. Indian companies today are expanding operations in overseas markets through both organic and inorganic means. There is a sense of optimism, and the ability to think big and execute large plans.

In addition, companies have developed the ability to quickly respond to changes in market conditions. For example, in response to the recent global economic slowdown, they aggressively reduced their inventories, realigned production levels and cut costs so as to rebase to the new cost price-demand

equation. It is important to note here that the corporate sector entered this challenging phase much stronger than what it was in the late 1990s, in terms of quality, operating efficiency, scale and balance sheet health.

7) Companies are increasingly going in for coopetition, i.e., getting together to become more competitive. Companies are taking minority stakes in one another, and negotiating tie-ups in marketing and production on a scale not witnessed before.

8) Trade unions and workers have responded positively to the economic reforms. Their open-minded approach towards adoption of new technologies and productivity linked wage agreements would go a long way in consolidating the future of Indian industry.

   Car plants of Maruti Suzuki and Hyundai in India have figured among the world's top 10. While only two plants in China figure on the list, there are none from the US. More factories in the country could make it to the list. Several global auto firms have invested or are investing in building car factories in India.

9) Liberalisation has altered the investment behaviour of Indian entrepreneurs. Industrialists have fast realised the role of scale economies, rapid technological growth and increased productivity. Indian companies are now going in for world-size plants. This will enable them to meet the competitive challenge of MNCs. Many Indian companies, for the first time, have crossed the billion-dollar mark in annual turnover.

   This has been made possible due to the following:

   — Reforms, such as devaluation of the rupee, have enhanced India's competitive advantage in labour and skill intensive industries.

   — Allowing freer imports of raw materials, intermediate goods, and capital goods has reduced the dependence of competitive industries on inefficient domestic producers of inputs and technology.

   — Import liberalisation appears to have made domestic production of critical inputs more efficient by enhancing domestic competitive conditions. One consequence is reduced prices of final products.

   — Reforms have contributed to a moderate shift into higher quality.

10) The restructuring process of the corporate sector has gained momentum with foreign collaborators seeking to enhance equity in the Indian ventures, to gain a foothold in the management. The money comes in with strings attached: board membership, due diligence and even some operational oversight.

The result is a radically altered environment for Indian industry; the number of manufacturers in many sectors of industry has increased, shortages have given way to surpluses, competition is becoming a way of business life in which only the fittest will survive — obviously, the rate of failure in business has increased. The brand acquisition market is vibrant.

In short, liberalisation has opened up a new era which stresses the importance of both economies of scale and quality of products; there hold the embryo of higher productivity and competitiveness both in the home market and the export markets, only if the Indian industry responds positively to the challenge thrown to it.

22.6.2 Negative Effects

1) Hundreds of small-scale units have closed down because liberalised imports killed the market for their products.

2) Liberalisation has altered the industrial structure in favour of goods in demand from the better-off section of society. These sections have benefitted from inflation, high interest rates on financial savings and the growth of high paid jobs with lavish perks.

3) The pattern of investment continues to favour the use of sophisticated plant and equipment at the expense of labour. Job growth is inadequate in both the urban and rural areas.

4) Industry's profitability has slumped and demand has been sluggish for the capital goods, for fairly long time, although it has been picking up lately. Profitability would have been lower but for 'Other Incomes' which are speculative incomes.

5) The new policy has left the public sector worse off. They are losing markets and their capacity utilisation has declined. The decline of the public sector is also undermining the country's technological base, whatever it was.

6) Bureaucratic hurdles prompted by the bureaucracy's subconscious desire to maintain the licence-permit raj remain almost as unchanged as they were when the reforms began; more than a decade and a-half down into the programme, the country has only a watered-down version of liberalisation. India ranks 116th out of 155 countries in the World Bank's annual rankings of countries based on an index of ease of doing business. A few drops of rain after a prolonged drought do not constitute a monsoon.

7) Liberalisation should have led to a Schumpeterian process of creative destruction and the replacement of old firms by new ones.

But that has not happened and sectors in which state-owned enterprises and other firms dominated activity prior to liberalisation continue to do so 20 years after the reforms began.

With opening up the economy has become far more unstable than earlier and the impact of this will fall on the already marginalised in society. One gets an uneasy feeling that if New Economies are not all about putting into practice Darwin's theory of survival of the fittest.

22.7 WEAKNESSES OF INDUSTRIAL POLICY

Absence of Suitable Policy for Exports: Today, the hightech industries are receiving a similar emphasis to that granted to their basic industry counterparts in the past, based on infant industry arguments. In the environment of limited export incentives and regulated labour markets, there seems little reason to believe today's infants will provide an engine for growth consistent with targets.

Distortions in Industrial Pattern: The current phases of investment following liberalisation also need to be given second look. While substantial investments might have been flowing into a few industries, the Government has reportedly expressed its concern over slow pace of investments in a few basic and strategic industries such as engineering, power, machine tools, etc. It has often been pointed

out that the rate of return in these sectors is not more than the expectations in the newer or 'Sunrise' areas. Thus, the rate of growth of the industries wherein sufficient investment is not coming could slacken. Such distortions in the investment pattern need to be rectified for the sake of balanced growth of industrial economy.

Need for Strengthening Interlinkages between New and Old Sectors: New sectors should have strong linkages with the old ones and should push up the latter towards modernisation and new product development. Unless interlinkages are strengthened, a part of impetus given by the new sectors could be lost through leakages abroad.

Labour Questions: Restructuring and modernisation of industries as a sequel to the new industrial policy could lead to displacement of labour. This would require rehabilitation schemes. Obviously, while modernising a particular industry, simultaneous efforts should also be made to identify areas of operations in which the labour could become redundant and also the areas of growth in which such labour could be absorbed.

Absence of Incentives for Raising Efficiency: Studies have shown that the incentives structure in the 1980s was somewhat perverse. It led industrial growth to move away from the sectors in which the country possesses comparative advantage and competitive strength. It instead encouraged industries which have very high domestic resource cost. International financial institutions like the World Bank also encouraged this trend. They focussed attention on internal liberalisation without adequate emphasis on trade policy reforms. This resulted in 'consumption-led growth' rather than 'investment' or 'export-led-growth'. This makes the growth process non-sustainable in a longer term framework.

Absence of Incentives for Technological Innovations: The policy of liberalisation has failed to achieve one of its major objectives — creating more innovative Indian firms. Perhaps we overestimated private sector's abilities. The fiercely competitive and fragmented industry structure has led to greater technology imports than to greater in-house innovative efforts.

Improperly-Defined Location Policy: In NIP, while mention has been made about 'hazardous chemicals and overriding environmental reasons', the location policy has been so defined that it would be quite difficult to ensure that the rapidly expanding urban conglomerations can be kept pollution free.

Further, new industries can be expected to gravitate towards the already well-established industrial centers which have a well-developed infrastructure. And the NIP environment could speed up this process of regional concentration. With the demand for infrastructure sector, the investment will tend towards the regions where the demand for infrastructure is the greatest. Since these regions are likely to be the ones which are already industrialised, it could lead to a new cycle of industry chasing infrastructure and infrastructure, in turn, chasing other industries.

Need for Proper Sequencing of Reforms: The Indian industry needs a breathing period in which to adjust, from the mould fashioned by the Nehruvian policy of self-reliance, to global competitiveness in size and technology. Without this, Indian industry may be running a three-legged race, as one industrialist put it, the third leg hampering his progress being uncompetitive policies. There is an urgent need for sequencing of reforms.

Distributional Consequences: If the industrial growth has to be sustained, the policy reforms have to address the distributional issues in the fundamental sense.

The qualitative evidence from Latin America shows that countries with highly skewed income distribution have a highly volatile growth process.

To sum up, there is a need for reviewing certain provisions of the policy to make it more meaningful and effective. With suitable changes in the industrial policy and elimination of controls, it is possible to provide a strong push to the country's industrial economy in years to come.

22.8 AGENDA FOR FUTURE ACTION

Industrial Policy for Emerging Economy

There is a point in every scientific experiment beyond which uncertainties reduce dramatically. The industrial policy reforms, which began about two decades ago, have arrived at that juncture. There are three key policy parameters that need to be kept in mind in designing the new economic strategy: (i) There should be a growth in quality jobs, (ii) The Indian economy should get strategic depth in capital goods such as power and telecom equipment, and (iii) defence and security should be kept in mind. There will be both technical and political challenges here. The technical challenge here is to identify industries that need a helping hand, and one assumes that government agencies have an understanding of India's factor endowments and comparative advantages. The political economy challenge is even more complex. Comparative advantage rapidly changes in the modern economy and technology cycles are getting shorter. Policy will have to be flexible if India is not to stagnate.

Agenda for action on further reforms includes the following:

1) 'Priority' should be accorded to eliminate remaining barriers to industrial production, investment and import of technology as quickly as possible.

2) "The old economy" dominates the Indian industry. We should not let the old economy become "order". Cement, steel and textiles will not vanish. Industrial policy must help rejuvenate and revitalise the old economy with the new economy tools like IT.

3) The Government's role should shift increasingly to restructuring unviable enterprises, ensuring fair business practices, safeguarding consumer interests and minimising the adverse effect of industrialisation on the environment.

4) A successful strategy for restructuring enterprises, whether public or private, must take due account of the legitimate interests of workers employed in these units. More generally, we must review and reform the current legislation for employment and industrial disputes to ensure that excessive rigidities are removed and long-term employment growth facilitated.

5) The perpetuation of regulatory measures and the imposition of 'Inspector Raj' can be particularly harmful for the growth of the small segment of industry. There has to be a systematic review of these regulatory measures.

6) Success in industrial and commercial restructuring will also hinge on our ability to devise sensible policies for use of urban land. The process of industrial restructuring requires large outlays of funds, which are presently blocked in land held by many concerned units. The Urban Land Ceiling and Regulation Act, 1976,[4] has to be suitably amended to facilitate the use of these blocked resources for productive restructuring.

7) While fetters on industrial investment and production have been sharply reduced at the Central Government level, it is important to recognise that they are still quite pervasive in many States. The requirements for licences, permits and inspections at the State and local levels continue to be onerous and extract a heavy toll in terms of effort and resources from industrial units. The State Governments have to act as front line implementers of reforms. A recent World Bank study reports that it takes 46 days for a foreign company to set up business in India, against 7 to 14 days in the US and Britain.

8) In wake of the recent reforms, the Companies Act must be rationalised and modernised. The government should change its role from that of controller to that of facilitator by making procedures transparent and eliminating delays.

9) As recently suggested by the World Bank, India should revitalise the informal sector, hasten private entry into public monopolies and promote agile firms, i.e. the firms that respond quickly to changing market conditions, believing that profits cannot be made by manipulating rules and excluding competition, but by improving their global competitive capabilities.

In short, by opening the economy to foreign competition, the Government has indirectly urged domestic industry to become more competitive. The foreign firms that do enter the Indian market are typically those with a proven track record in multinational operations, a lot of dough at their disposal. The Government should, thus, not handicap domestic firms with archaic laws, but ease the way for them to compete effectively with the foreign entrants. One goes to a cricket match not just to watch good cricket, but also to see the local team play well.

Check Your Progress 3

1) State in brief the positive effects of the New Industrial Policy, 1991.

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2) State in brief the negative effects of the New Industrial Policy, 1991.

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3) Identify the key policy parameters need to be taken into consideration for new economic strategy.

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[4] As part of the exercise to amend the Urban Land (Ceiling and Regulation) Act, 1976, the centre has proposed, in March 1997, 100 per cent increase in the ceiling on the floor area for land holdings. The existing ceilings on the floor area for commercial buildings refer to 500 sq. meters for category A cities, 1,000 sq. meters for category B cities, 1,500 sq. meters for category D cities. It is also proposed to levy a shelter tax on commercial buildings, as also to change the compensation package for land owners.

22.9 LET US SUM UP

During the first four decades of economic planning, industrial policy in India was characterised by Controls, Indianisation and Abstinence. The economy that developed during this period came to be identified as the old economy. This economy can be replaced in wake of the new industrial policy that was build on three pillars of liberalisation, privatisation and globalisation (LPG). The new economy will hit a lot of industries within the old economy; it has already started killing industries within its own economy through better technology. Jobs will be cut and jobs will be out-sourced to places with cheap labour. But it does not mean that it will deprive labour of its dignity and force it to live as "children of a lesser God".

The success of the new economic policy at the end depends on how humanity as a whole accepts it over a period of time. If it increases the differences between the haves and the have-nots, if it infringes into privacy, security, equality and basic human rights, history has shown that revolutions do happen again.

22.10 EXERCISES

1) "Rapid industrialisation and diversification of the industrial structure have been the twin objectives of industrial policy of India." Enumerate.

2) State the features of New Industrial Policy, 1991 and give a critical evaluation of the Policy.

3) "The policy regime of 1950s has been criticised for their inward orientation, restrictive and discretionary approach and inefficiencies." Comment. What changes have taken place in the policy framework in 1991?

4) What policy changes should be made in India's trade and industrial policies to ensure rapid growth of GDP, while maintaining adequate macro-economic balance?

5) Explain the need for liberalisation of industrial policy in India. Evaluate the impact of this policy.

22.11 KEY WORDS

Industrial Policy : Set of rules and regulations imposed by state that influence the pattern of industrial growth.

Industrial License : A written permission by the state to set up a new enterprise, various critical decisions embedded and that permission.

22.12 SOME USEFUL BOOKS

Akelrof George and Robert Schiller (2009): *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters For Global Capitalism,* Princeton University Press.

Basu, Kaushik and Ravi Kanbur (eds.), (2009): *Arguments for a Better World*, Oxford Unviersity Press, New Delhi.

Bhaduri, Amit, (2009): *The Face You were Afraid to See: Essays on the Indian Economy,* Penguin.

UNIT 14 INDIAN FINANCIAL SYSTEM: MONEY MARKET AND MONETARY POLICY

Structure

14.0 OBJECTIVES

The purpose of this unit is to develop among learners an understanding of the nature and role of the Indian money market, and how monetary policy is implemented by the Reserve Bank of India (RBI) in the country. After going through this unit, you will be able to:

- state the role of the money market;
- describe the different components of the money market;
- explain the mechanism of RBI intervention in the money market;
- state the objectives of monetary policy in general, and in India in particular;
- identify the targets and operating targets of monetary policy in India; and
- analyse the process and mechanism adopted by RBI in implementing monetary policy in India.

14.1 INTRODUCTION

This unit focuses on two inter-related aspects of the Indian financial system. First, it discusses the components and functions of the money market. Since

money market is the focal point through which the central bank of the country (i.e., the Reserve Bank of India) executes the monetary policy, the nature of its intervention in the money market is also discussed. In view of the discussion of the role and functions of money market and the nature of RBI intervention in the money market, second part of the unit explains how monetary policy is implemented in India. In fact, in line with the financial sector reforms, this aspect has undergone substantial changes over the 1990's. The changes in the structure and functioning of the money market have been brought about by the RBI in order to change the ways in which it conducts the monetary policy. The important changes in the money market and the corresponding changes in the way monetary policy is executed, have been discussed. However, the underlying objective has been to apprise you of the latest status of the money market and monetary policy.

14.2 MONEY MARKET IN INDIA

In theoretical macroeconomics, the term "money market" refers to the market for financial assets. However, in the context of financial markets, money market refers to the market for short-term funds, i.e., up to one-year maturity. In brief, money market is the place where lending and borrowing is done through instruments having an original maturity of up to one year.

Interest rates in this market are indicators of short-term liquidity position in the financial system. From the point of view of monetary policy, the money market plays an extremely important role since RBI intervenes in this market to control the short-term liquidity positions and interest rates in the economy through this market. In view of the growing inter-linkages between the money market, dated Government securities market and foreign exchange market, the money market conditions affect the other two markets, especially the foreign exchange market. In short, the money market provides a mechanism to balance the demand for and supply of short-term funds. This market provides the opportunity to the eligible participants to invest their short-term surplus funds and to borrow short-term funds in case of deficit.

Money market consists of the call/notice/term money market, and a number of instruments like treasury bills, repos (and reverse repos), commercial papers, certificates of deposits, and bill rediscounting.

14.2.1 Call/ Notice/Term Money Market

The call money market is the market for borrowing and lending for short-term periods (usually upto 14 days, but at times more than that) mostly by commercial banks. It is a telephonic market, i.e., deals are struck over telephone and reported to RBI. Commercial banks often face temporary shortages of funds (e.g., to meet CRR and SLR requirements, or sudden outgo of funds) or temporary surpluses. When a bank is in shortage of funds, it borrows from another bank which is in surplus. Deals in this market are struck over telephone.

If borrowing (or lending) is made for one day (overnight), it is known as "Call Money". This segment is also called overnight money market. If the maturity of borrowing (or lending) is more than 1 day but up to 14 days, then it is known as "Notice Money". "Term Money" refers to money borrowed (or lent) for more than 14 days but less than one year. In Indian money market, most of the transactions are of call money and notice money.

In this market, commercial banks and primary dealers can both borrow and lend, but financial institutions (LIC, UTI, GIC, IDBI, NABARD, ICICI) and

mutual funds can only lend. RBI, as regulator, routinely participates in the market to inject liquidity (lend) or to mop up liquidity (borrow). As part of the financial sector reforms, RBI has been progressively moving towards making this market a purely inter-bank market (including the primary dealers) by gradually limiting the scope of participation of non-bank players.

14.2.2 Repos/Reverse Repos

In a repo (also known as ready forward contract) transaction, one party borrows funds for a specific period (known as repo period) against the collateral of specific securities at pre-determined rate (known as repo rate). Although the primary objective is to borrow funds, the legal title of the security also changes. That is, the first party sells the security to the second party and agrees to purchase it back at a pre-determined price at a future date. Effectively, the first party (which sells the security) gets access to funds for the intervening period between the sale of the security and its repurchase, known as repo period.

Similarly, a party that needs to invest a temporary surplus cash, or needs to increase its holding of securities (e.g., banks requiring to meet SLR obligation), will enter into an opposite type of transaction with another party – it will buy the security and will agree to sell it back at a future date at a pre-determined price. This transaction is known as reverse repo transaction. In other words, from the point of view of the seller of the security, it is a repo transaction, and from the point of view of the buyer it is reverse repo transaction. A particular deal may be termed as repo or reverse repo depending on who initiated it. Essentially, repo is a means of borrowing against the collateral of the security that is sold now and bought back at a future date, and reverse repo means lending against the collateral of the security that is bought now and sold back at a future date.

In India, apart from the Reserve Bank, only scheduled commercial banks (excluding regional rural banks) and primary dealers can participate in repo/reverse repo transactions. Non-bank participants (e.g., financial institutions) can only lend money to the eligible participants (RBI, commercial banks, PDs) through reverse repo. In a move to broad base the repo market, companies listed on Indian stock exchanges have been allowed to lend their surplus cash in the repo market from April 2005. The securities eligible for repo/reverse repo transaction are specified as the Central and State Government securities including treasury bills.

For the purpose of absorption of short-term liquidity, RBI carries out overnight (one day) repo auction at a fixed rate. This means, RBI is ready to sell as much securities as is demanded by the participants at the fixed rate. This rate is fixed in the sense that it does not change on a daily basis depending upon the supply-demand condition of short-term liquidity, as would be the case for a variable rate repo auction. Changes in the fixed repo rate are usually made in the Annual Monetary and Credit Policy or in the Mid-Term Review of the Monetary and Credit Policy.

Repo auctions (multiple price auction, or variable rate repos) on Government securities were introduced in December 1992. Initially, repo auctions were conducted for tenors of 1 or 2 days that was later extended up to 14 days. Auctions were discontinued in early 1995 on the face of lack of market demand in view of the tight liquidity conditions. Repo auctions were re-introduced in early 1997 but this time with 3 to 4 day cycles. Fixed rate repos (uniform price auctions) with tenor of 3 to 4 days were introduced in

November 1997. In recent past, RBI has conducted auctions of fixed rate repos with tenor of 7 and 14 days, as well as of variable rate overnight repos. With effect from November 1, 2004, auction of fixed-rate repos of 7 and 14 days tenor and variable rate overnight repos have been discontinued, although RBI reserves the right to use them at any point of time if the situation so warrants. Currently, fixed-rate repo and reverse repo auctions are conducted by the RBI on a daily basis (excluding Saturdays, Sundays and other public holidays) for 1 day (overnight) tenor.

In order to inject liquidity into the system, RBI conducts fixed rate auctions of reverse repo at a rate higher than the repo rate. The reverse repo rate is linked to the repo rate in the sense that it is set at specific percentage point above the repo rate. The fixed repo rate was increased from 4.50 per cent to 4.75 per cent and the spread between the repo rate and the reverse repo rate has been reduced to 125 basis points (100 basis point = 1 per cent) from 150 basis points with effect from October 27, 2004. In view of rising inflationary expectations, the fixed repo rate was further raised to 5 per cent effective from April 29, 2005. However, the reverse repo rate was unchanged at 6 per cent, so that the spread between the two rates currently stands at 100 basis points. Thus, in spite of the changes in the repo rate in last two years, the reverse repo rate has been kept equal to the bank rate which is currently set at 6.

The repo/reverse repo transactions that the RBI undertakes are primarily for the purpose of conducting monetary policy. The eligible participants can also engage into repo transactions among themselves at market-determined rates. However, in the presence of the fixed repo rate of the RBI, the market determined repo rate does not deviate much from the fixed rate.

It may be noted that the way the terms repo and reverse repo have been defined above, is just opposite to the international practice. That is, *what is repo in Indian terminology is reverse repo in international parlance, and what is reverse repo in India is internationally known as repo.* In a fast globalising environment, this may create confusion. Consequently, *RBI has changed the definitions of repo and reverse repo to bring them in line with international practice with effect from 27th October 2004. However, in this unit, we have throughout followed the older (Indian) definition.*

14.2.3 Treasury Bills

Treasury bills are short-term securities (up to 364 days) issued by the Central Government. Currently, treasury bills are issued with three maturities – 91 days, 182 days and 364 days. Being free of default risk, yields on the treasury bills serve as benchmarks for most other short-term rates. Treasury bills market is the place where Central banks in most countries prefer to intervene in treasury bills market for influencing liquidity and short-term interest rates. The development of this market is crucial for the conduct of open market operations.

Treasury bills are issued at a discount to the face value. For example, a 91-day treasury bill of face value Rs. 100 is issued at a price of Rs. 98.53. This means that the investor will pay Rs. 98.53 at the time of purchasing the bill, and will receive Rs. 100 on maturity after 91 days. The yield in this example is calculated as 5.9677 per cent [= {(100 – 98.53)/ 98.53} × (364/91)]. The second term (364/91) annualises the yield. Note that the year is taken as consisting of 364 days. With effect from October 27, 2004, RBI has changed this convention and now the yield calculation is done on the basis of 1 year = 365 days.

A system of auction of 91-day treasury bills and a vibrant market for this instrument existed before the 1960's. Two events destroyed this market. First, the system of selling 91-day treasury bills through auctions was discontinued in the mid-1960's and was replaced by on-tap 91-day treasury bills. This means that now the treasury bills would be sold throughout the week at a fixed interest rate instead of through auctions conducted on a weekly basis. The on tap bill rate used to change in line with the bank rate till 1974, since when the rate was kept unchanged at 4.6 per cent for years. On tap bills were sold to RBI as well as to other market participants. Second, in the mid-1950's, a system of ad-hoc treasury bills was introduced. These bills were automatically issued (to RBI) as and when the cash balance of the Central Government with the RBI fell below a certain level. This system brought in an era of uncontrolled monetisation of the Central Government's deficit. Market interest in the treasury bills revived once again with the introduction of 182-day treasury bills in November 1986 and establishment of Discount and Finance House of India (DFHI) in 1988 to provide a secondary market for treasury bills (and for a number of other money market instruments).

Reforms in the treasury bills market began with the introduction of 364-day treasury bills on fortnightly auction basis since April 1992. A system of auction of 91-day treasury bills was introduced in January 1993. The most important change came about when the Central Government and the RBI entered into an agreement to discontinue the ad-hoc treasury bills from April 1, 1997. Since that time (i.e., beginning in 1997-98), the automatic monetisation of fiscal deficit has been stopped and the Central Government has relied on market borrowing to finance the fiscal deficit. This move, apart from creating some independence for the monetary policy, has also given a big boost to the development of the debt market.

14-day treasury bills were introduced on June 6, 1997 and discontinued with effect from May 14, 2001. 182-day treasury bills were introduced in November 1986. Auctions of these treasury bills were not held between April 28, 1992 and May 25, 1999, and were discontinued with effect from May 14, 2001. These treasury bills were re-introduced in the first week of April 2005.

The investors in treasury bills include banks, primary dealers, financial institutions, provident funds, insurance companies, NBFCs, FIIs and State governments.

14.2.4 Commercial Paper

Commercial papers (CPs) are short-term (up to 1 year) unsecured borrowing through issue of financial instruments (called commercial papers) by large, reputed and financially strong corporates enjoying high credit rating. Non-financial corporates (and primary dealers and All India Financial Institutions), having a specified amount of net worth (currently specified as Rs. 4 crore or more) and having a high credit rating (P2 or its equivalent) can issue commercial papers for any period between 7 days (brought down from 15 days with effect from 26th October 2004) to 1 year. Currently, CPs can be issued in denomination of Rs. 5 lakh and in multiples of Rs. 1 lakh thereafter. The investors in CPs include banks, financial institutions, mutual funds and high net worth individuals.

14.2.5 Certificate of Deposits (CDs)

CDs are instruments of short-term borrowing by commercial banks. All scheduled commercial banks (excluding RRBs and cooperative banks) can

issue CDs for a minimum period of 15 days and a maximum of 1 year in denominations of Rs. 5 lakh and in multiple of Rs. 1 lakh thereafter. All India Financial Institutions (AIFIs) can also issue CDs, but for maturity of 1 year to 3 years and, hence, CDs issued by the AIFIs cannot be considered as a money market instrument. The CDs are just like bank fixed deposits, but with the difference that the CDs are freely transferable by an endorsement (just like equity shares or bonds) while bank fixed deposits are not. Like treasury bills, CDs are also issued at a discount to the face value. The discount rate or the yield on CDs can be freely negotiated between the issuer and the investor. CDs can be issued to individuals, corporations, trusts, institutional investors, etc.

From the point of view of the issuing bank, CDs are rather high cost source of fund.

14.2.6 Bills Rediscounting

A bill of exchange arises in respect of sale of goods when the buyer likes to make the payment sometime later (say, after he resells the goods) and the seller likes to receive the payment earlier than that. In this situation, the seller (or the drawer) draws (or makes) a bill of a given maturity on the buyer (the drawee) and sends it to the buyer. The buyer then endorses or accepts the bill, which means that he agrees to make the payment at or within a future date specified in the bill, and sends it back to the seller. The seller, who needs money as early as possible, presents this accepted bill to his bank, and gets a payment from the bank against this bill. The bank actually purchases the bill from the drawer (seller of goods) at a price slightly less than the amount represented in the bill (i.e., the amount that the buyer agrees to pay at a later date). This process is known as discounting of bills by the bank. The bank then collects the money as and when the drawee (the buyer of goods) makes the payment. The bank earns the difference between the purchase price (or the discount price) and the bill amount, which is also the cost to the drawer of the bill for getting the payment earlier than when the drawee (buyer) pays. Of course, the bank takes precautions so that the buyer's payment is guaranteed (e.g., a security from the drawer or seller held as collateral, an arrangement with the buyer's bank, etc.). Since the bills of exchange are negotiable instruments, the bank can sell the bills to another party (e.g., another bank). A bank can also place the bills discounted by itself with the central bank (i.e., the RBI) and get money for use in its lending activities (of course, at a certain rate of interest – usually the Bank Rate). This process is known as rediscounting of bills by the central bank.

Bills can be inland (when it is drawn and payable in India) or foreign (when it is drawn outside India and payable in or outside India). Bills can also be classified as demand bill (when the bill is payable by the drawee immediately on presentation before him) or usance bill or time bill (if the bill is payable at a future date).

In India, although banks regularly discount a large volume of bills, a secondary market for rediscounting these bills is lacking. Earlier the RBI used to provide rediscounting facility through its discount window, but the practice seems to have been discontinued from the early 1980's.

14.2.7 RBI's Intervention in the Money Market

In order to control the liquidity position in the financial system, RBI regularly intervenes in the money market either to absorb liquidity when it is in excess

or to inject liquidity when there is a shortage of liquidity. Two important ways in which the RBI intervenes in the money market are through its standing facilities or refinance and the Liquidity Adjustment Facility (LAF). An understanding of these aspects is absolutely necessary to understand the way monetary policy is conducted in India.

14.2.7.1 RBI's Standing Facilities (Refinance) to Commercial Banks

The Central Bank, as a lender of last resort, provides liquidity to banks when the latter face shortage of liquidity. This facility is provided by the Central Bank through its discount window. Commercial banks can borrow from the discount window against the collateral of securities like commercial bills, Government securities, treasury bills, or other eligible papers. Some central banks even allow commercial banks to borrow from the discount window without any collateral. In India, this type of support of the Central Bank earlier took the form of refinance of loans given by commercial banks to various sectors (like exports, agriculture, etc.). Under this facility, commercial banks could borrow from the RBI certain percentage (specified by the RBI from time to time) of the loans given by them to the specified sectors. RBI used the sector-specific refinance facilities as an instrument of credit policy to encourage or discourage lending to particular sector by varying the terms and conditions of refinance. However, in line with the financial sector reforms, RBI has withdrawn from the direct and micro-management of credit. Accordingly, the system of sector-specific refinance schemes (except export credit refinance scheme) were withdrawn and were replaced by a Collateralised Lending Facility (CLF) in April 1999 under the Interim Liquidity Adjustment Facility (ILAF), wherein commercial banks could borrow funds from the RBI (subject to certain limits) at interest rates equal to or above the Bank Rate. From June 2000, the CLF was withdrawn. Currently, RBI provides financial accommodation to the commercial banks through repos/reverse repos under Liquidity Adjustment Facility (LAF). Additionally, primary dealers are also provided with financial accommodation (borrowing facility) against the collateral of Government securities and treasury bills. Refinance of rupee export credit also continues.

14.2.7.2 Liquidity Adjustment Facility (LAF)

As part of the move from direct to indirect instruments of monetary policy, and to be able to control the money market rates in an effective manner, the Narasimham Committee on Banking Sector Reforms (1998) recommended the withdrawal of all general and sector specific refinance facilities and move towards a liquidity adjustment facility through the operations of repos and reverse repos. Accordingly, an Interim Liquidity Adjustment Facility (ILAF) was introduced with effect from April 21, 1999. According to the ILAF, general refinance facility was withdrawn (refinance of rupee export credit was retained) and was replaced by a collateralised lending facility (CLF). Under CLF, banks could borrow an amount up to 0.25 per cent of their fortnightly average outstanding aggregate deposits for two weeks at the bank rate. An Additional CLF (ACLF) allowed banks to borrow an additional amount of CLF (i.e., additional 0.25 per cent of fortnightly average outstanding aggregate deposit in 1997-98) for two weeks at Bank Rate plus two percent. For an additional period of two weeks beyond the initial two weeks, CLF and ACLF would attract an additional interest rate of 2 per cent above their respective rates (i.e., CLF at Bank Rate plus 2 per cent, and ACLF at Bank Rate plus 4 per cent). Besides, liquidity support to the Primary Dealers were

provided against the collateral of Government securities at the Bank Rate for a period of 90 days.

The Interim Liquidity Adjustment Facility (ILAF) was replaced by a full-fledged Liquidity Adjustment Facility (LAF) in June 2000. With the introduction of the LAF, the CLF and ACLF stood withdrawn, and the RBI began to manage liquidity in the system through the auction of repos and reverse repos. Initially, RBI conducted auctions of variable rate repos for 1 to 14 days, but later on reverted to auction of fixed-rate repos for 1-day tenor only (3 day tenor on Fridays). However, the RBI deserves the right to re-introduce variable rate repos with longer tenor (of up to 14 days).

Under the earlier system wherein RBI used to control the liquidity in the system through changes in CRR and OMOs, RBI could either influence the quantum of liquidity (by changing CRR) or the cost of liquidity, i.e., the interest rates (through OMO). But after the introduction of the LAF, RBI can control both the quantum of liquidity (by accepting bids up to a certain amount in the repos/reverse repos) and the interest rates. RBI's control over the interest rates emanates from the fact that the repo rate, that acts as a floor, and the reverse repo rate at 100 basis points above the repo rate, that acts as the ceiling, together provide an informal corridor within which the call money market rates fluctuate.

Check Your Progress 1

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Write three sentences about the role of money market in an economy.

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2) Write five sentences about the RBI's intervention in the money market.

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3) State whether following statements are True or False.

i) RBI uses repos to absorb liquidity. ( )

ii) RBI uses reverse repos to absorb liquidity. ( )

iii) Treasury bills can only be issued by the Central Government in India. ( )

iv) Treasury bills are issued at a discount to the face value. ( )

v) Commercial banks in India can issue commercial papers. ( )

vi) Non-bank corporates can issue CDs in India. ( )

14.3 MONETARY POLICY IN INDIA

Monetary policy is implemented under what is called a monetary policy framework that consists of: (a) the objectives of monetary policy; (b) the analytics of monetary policy (that focuses on the transmission mechanism); and (c) the operating procedure (consisting of operating targets and instruments). In this section, we will elaborate on these aspects in Indian context.

14.3.1 Objectives of Monetary Policy

Price stability (or controlling inflation) and maintaining economic growth are the most commonly pursued objectives by central banks across the world. In view of large-scale financial crises that occurred in a number of countries in the 1990's (notably in Mexico, South Asia, Brazil and Argentina), achieving financial stability to pre-empt such crisis or to protect the national economy from the ill effects of such crisis occurring in another country has become an additional objective of monetary policy. However, it is often not possible to achieve all these objectives by monetary policy alone. It is because the objectives of monetary policy are interrelated, and there are trade-offs as well. For example, there is often a conflict between inflation and unemployment – inflation can be reduced at the cost of higher unemployment. Similar trade-offs exist among other objectives as well. Thus, in view of multiple objectives, all of which are equally desirable, academicians and policy-makers agree that monetary policy should target price stability, leaving growth and employment to be targeted by fiscal and other policies. Although many developed countries assign the objective of price stability singularly to monetary policy, a notable exception is the US where monetary policy objectives include maximum employment, stable prices and moderate long-term interest rates.

India's approach in respect of monetary policy objectives takes into account the ground level realities in the country. Accordingly, maintaining price stability and ensuring an adequate flow of credit to the productive sectors (to maintain the economic growth) of the economy have been the major objectives of monetary policy in India. However, depending on the specific circumstances of the year, relative importance attached to the two objectives shift from year to year. In the post-reforms period, a realisation has evolved that in an open economy as India is, in the post-reforms period, maintenance of price stability is more important. This is because in addition to the domestic factors leading to inflation, foreign inflation may automatically get imported into the country if proper safeguards are not adopted. Thus, it is increasingly being recognised that the central bank should target price stability because real growth itself would be in jeopardy if inflation rates go beyond the margin of tolerance.

14.3.2 Analytics of Monetary Policy

The process through which monetary policy intervention gets transmitted to the ultimate objectives like inflation or growth is known as "monetary transmission mechanism". There are four known ways of transmission mechanism, or transmission channels: (a) the quantum channel (e.g., relating to money supply and credit); (b) the interest rate channel; (c) the exchange rate channel; and (d) the asset price channel. The nature and relative importance of these channels in a particular economy depends on the stage of development of the economy and its underlying financial structure. For

example, the exchange rate channel is expected to be important in an open economy, whereas the quantum channel is likely to be important in an economy where banks are the major source of finance (as against the capital market). Besides, these channels do not function independently of each other, and there could be considerable feedbacks and interactions among them.

14.3.3 Operating Procedures: Instruments and Targets

Day-to-day implementation of monetary policy is known as monetary policy operating procedure. Monetary policy seeks to achieve its ultimate objective (of price stability, growth, etc.) through some intermediate targets. These intermediate targets could be exchange rate, money supply growth or a level of interest rate. The RBI has adopted the stance (especially in the 1990's) that the demand for money function is fairly stable in India, and, hence, a desired level of money supply (broad money or M_3) growth has been set as the intermediate target. Accordingly, the RBI sets a desired target of money supply (broad money) growth for the forthcoming period, and announces this target publicly through the Governor's statement on monetary and credit policy. This targeted rate of growth of money supply is decided keeping in view the expected rate of growth of GDP and a tolerable level of inflation. Given the desired level of growth in broad money, the required expansion in reserve money is then determined given the money multiplier.

However, the fiscal situation and external sector position in particular years are also taken into account while deciding the targeted rate of broad money expansion. For example, if in a particular year, the fiscal deficit increases, and the increased deficit is financed by an increase in market borrowing by the Government, then the reserve money expansion target is modified so as to allow for larger increase in liquidity to accommodate the increased market borrowing of the Government. If this is not done, there will be a shortage of liquidity in the system and the resulting upward pressure in interest rates. Similarly, if the foreign currency inflows suddenly increase in a particular year leading to increase in money supply in the economy, the targeted reserve money expansion must be brought down so that the broad money expansion after the increased foreign exchange inflows do not lead to higher inflation.

14.3.3.1 Instruments of Monetary Policy

Central banks seek to achieve these intermediate targets (for example, broad money expansion) through operation of monetary policy instruments. These instruments are of two types – direct and indirect. The direct instruments include cash reserve ratio (CRR), liquidity reserve ratios, directed credit and administered interest rates. CRR specifies the amount of reserves, banks need to maintain as cash or with the central bank as percentage of their liabilities (deposits). Liquidity reserves ratio, called Statutory Liquidity Ratio (SLR) in India, specifies the amount of money banks must invest in Government securities (and bonds of PSUs) as proportion of their deposits. Directed credit prgramme is used to channelise flow of credit to preferred/priority sectors. Administered interest rates are used to control lending and deposit rates directly. The direct instruments (except administered interest rates) influence the financial system through changing the quantity of credit availability. For example, a fall in CRR or SLR releases certain amount of liquidity into the financial system, which, then, causes the rates to change.

As opposed to this, the indirect instruments generally operate through price channel. That is, these instruments first cause the rates (or prices) to change, which, in turn, causes flow of credit/liquidity to change. The indirect

instruments consist of the repos (repurchase agreements), Open Market Operations (OMOs), refinance facility, and the discount window of RBI. The repos/reverse repos are used to mop up or inject liquidity for a short duration. OMO is resorted to when the central bank attempts to change the liquidity condition for a longer term. Both these instruments are operated by the RBI at its own discretion. As opposed to this, standing facilities (refinance of eligible export credits) and discount window facility (rediscounting of bills or borrowings from RBI by banks) are accessed by the banks at their discretion.

While the direct instruments are effective (a change in such an instrument almost instantaneously affects the intermediate target), they introduce inefficiency in the market. For example, an increase in CRR (with the objective of reducing liquidity in the system) is applicable to all banks in the system, and, hence, penalises the banks with good liquidity management. Indirect instruments are more appropriate in a market-based system. However, the effectiveness of the indirect instruments depends on the extent of development of the supporting financial markets and institutions. The structure of Indian financial markets has witnessed a gradual transformation in the 1990's under the regulation of RBI in such a manner that conditions conducive to the operation of indirect instruments of monetary policy have been developed to a satisfactory extent.

14.3.3.2 Operating Targets

The instruments of monetary policy seek to attain a particular level of a variable, known as operating target, in order to achieve the broader objectives like price stability and/or growth. Usually, these operating targets include bank reserves and/or a very short-term interest rate like the over-night inter-bank call money rate. Since late 1980's, RBI followed the practice of targeting bank reserves in order to achieve the desired level of broad money expansion. However, in view of the evidence that interest channel was becoming important due to structural transformation in the financial sector resulting from reforms, it was felt that targeting bank reserves would be inefficient. Since April 1998, RBI has adopted a multiple indicator-based approach, wherein rates and flows from various markets are monitored and targeted.

14.3.4 Monetary Policy in the Early 1990's

Until the beginning of the 1990's, before the reforms were initiated, Indian financial market was highly segmented with very little inter-linkages (if any) among the various segments. The money market was in existence, but lacked depth and liquidity. Interest rates – on deposits, credit and Government securities – were highly regulated. Through a high SLR requirement (38.5 in the early 1990's), the Government used to pre-empt a large portion of the deposits of the banking system at below-market rates. Another significant portion of the lendable resources of the banking sector was directed toward priority sector at highly subsidised rates of interest.

The system of financing of fiscal deficit of the Government through ad-hoc treasury bills (TBs) had serious implications for the conduct of monetary policy. Originally, ad-hoc treasury bill was designed as an instrument to raise short-term credit by the Central Government from the RBI. Over time, it became a practice to roll over the ad-hoc TBs on their maturity, and issuing fresh ad-hocs to raise more finance. Since the ad-hoc TBs were held by the RBI, and not sold to the market, every issue of such TBs amounted to increase in money supply in the economy. Had RBI was in a position to re-sell these TBs to the market, it would have meant a transfer of purchasing power from

the market to the Government through a loan, and not addition to the purchasing power in the system. Even in the situation prevalent at that time where RBI could not re-sell the ad-hoc TBs to the market, had the ad-hocs been repaid on their maturity, the money supply would have reduced by an equal amount. But continuous roll-over and fresh issuance of ad-hoc TBs amounted to continuous increase in money supply. Thus, the fiscal deficit of the Central Government used to be continuously financed automatically through creation of money. This process is known as automatic monetisation of Government deficit. Apart from the ad-hoc TBs, the RBI had to purchase dated Government securities that were not taken up by the market. These two components (RBI's purchase of ad-hocs and dated Government securities) together constitute Net RBI Credit to the Central Government, and increase in this figure during a period represents increase in reserve money during that period.

Automatic monetisation of deficits led to considerable upward pressure on the prices. Consequently, the rate of inflation continued to be rather high on a sustained basis since the 1960's through the 1990's (excepting first half of 1980's), although intermittent supply shocks like the oil price hike of 1973 and late 1970's played a role in some of the years. To curb the adverse impact of automatic monetary expansion on the prices, CRR was raised gradually from 3 per cent in the early 1970's to 15 per cent in the early 1990's.

Apart from automatic monetisation of Government deficits, rising deficits of the Central Government throughout the 1960's, 1970's and 1980's were also financed by the banking system through its support of the former's borrowing programmes. Initially, interest rates on Government securities were kept artificially low to minimise the cost of Government debt, but had to be increased later on to improve their attractiveness. Even the higher interest rates were not enough to get voluntary subscription. Consequently, in order to force the banks to subscribe to the Government securities, the SLR was gradually raised to 38.5 per cent by early 1990's.

In this situation of continuous increase in money supply, monetary policy had very little room to play. Monetary policy concentrated on neutralising the inflationary impact of fiscal deficits with the use of direct instruments, especially CRR. Thus, monetary policy used to play no more than a second fiddle to the fiscal policy.

By early 1990's, both CRR and SLR reached very high and close to their maximum permissible levels, and, hence, lost their effectiveness as monetary policy instruments in an economic environment characterised by continuous monetary expansion. Thus, the situation became unsustainable by the early 1990's, and reforms became unavoidable.

14.3.5 Monetary Policy in the Late-1990's Onwards

Conduct of monetary policy has undergone a sea change following reforms in the financial sector. Apart from changes in objectives and targets including operating targets of monetary policy, there has been a gradual shift from direct instruments to indirect instruments. The shift has been made possible by the significant reforms in the structure of financial markets.

Until 1997-98, monetary policy used to be conducted in India with expansion of broad money (M_3) as an intermediate target. The desired rate of growth of M_3 used to be determined keeping in view the expected GDP growth and a projected level of inflation. Reforms in the financial sector have brought about changes in the transmission mechanism of monetary policy with interest rate

channel gaining importance. The earlier approach was then replaced with a multiple indicator-based approach since 1998-99. This means that targeted growth in M_3 or bank reserves were not determined simply in view of expected GDP growth and expected inflation, but in the light of recent trends in a range of other variables as well – rates of return in different markets (money, security and Government securities), credit growth, exchange rate, capital flows, etc. In other words, although bank reserves remain the operating target, other rates and flows are also targeted to fine tune the financial system.

The shift from the direct instruments to indirect instruments has been made possible through a series of carefully crafted and correctly sequenced steps of reforms as explained below.

a) OMOs (including repos) were re-activated in 1992-93 in order to develop a market-based mechanism to inject/absorb liquidity from the system.

b) The Liquidity Adjustment Facility (LAF) was introduced in two phases in April 1999 and June 2000. The Reserve Bank is now able to control liquidity in the system on a daily basis through repos/reverse repos under LAF. This was impossible in the earlier structure when CRR was the primary tool to control liquidity, because CRR could be changed at best on a fortnightly basis. The RBI absorbs liquidity at the fixed repo rate (currently 5 per cent) at times of excess liquidity, and injects liquidity at times of tight monetary conditions through reverse repo rate fixed at 100 basis points above the repo rate. Thus, these two rates provide an informal corridor within which call money rates and other short-term rates fluctuate. This is because if call money rate goes below the repo rate, banks can borrow funds from the call money market and park the same with RBI at the fixed repo rate and can make some sure profit. Similarly, if the call money rate goes above the reverse repo rate, banks can borrow from the RBI at the reverse repo rate and lend in the call money market, and can make some sure profit.

c) The Bank Rate was re-activated in April 1997. Initially, all financial accommodation extended by the RBI was linked to this rate. With gradual development of the repo/reverse repo market and introduction of LAF, Bank Rate is used more to signal the RBI's view of interest rates to the market.

d) In order to disentangle monetary policy from the clutch of fiscal policy, an auction system for the Central Government's market borrowing programme was introduced in June 1992. After this, an increasing portion of fiscal deficit was financed by market borrowings at market-determined rates of interest. The system of ad-hoc treasury bills was terminated in 1996-97, and automatic monetisation of fiscal deficit through ad-hoc treasury bills was discontinued from April 1997.

e) The interest rates were deregulated gradually with lending rates deregulated first followed by deregulation of deposit rates. Starting from September 1991, a system of prescription of multiple rates for loans to various sectors and various sizes were gradually withdrawn (except for a few areas like agriculture, small scale industries and export credit). The minimum lending rate was withdrawn and banks were given full freedom to determine their lending rates for loans above Rs. 2 lakh in October 1994. At the same time, banks were required to announce prime lending rate (PLR). Later on, banks were allowed to set different PLR for different maturities, and also to lend at sub-PLR (below PLR) rates to highly creditworthy borrowers.

f) Deposit rate deregulation started in April 1992 with removal of RBI-prescribed multiple rates for different maturities and replacing these with a single ceiling rate. Afterwards, the scope of the ceiling rate was gradually reduced by removing the ceiling on deposits of maturity of over two years in October 1995, on deposits of over 1 year maturity in July 1996, and on all deposits in October 1997. The only deposits rate that is currently determined by RBI is the savings bank rate (currently at 3.5 per cent since March 2003).

g) Interest rate deregulation is not enough for the market-based indirect instruments of monetary policy to be effective. This was required to be supported by the development of the missing segment of the financial market – a vibrant market for short-term funds.

The size and efficiency of the short-term segment of the financial market (i.e., the money market) is crucial for the conduct of monetary policy. Larger is the depth and breadth of this market, easier it is for the monetary policy instruments to achieve its goal of influencing the operating target. The more efficient the money market is, the less time a change in the monetary policy instrument takes to affect the operating target, i.e., the higher is the speed of adjustment.

Two factors explain the underdevelopment of the shorter end of the financial markets until the early 1990's – cash credit facility offered by the commercial banks to its borrowers, and the availability of the 4.6 per cent on tap treasury bills.

Under the cash credit system, borrowers were given a limit up to which they could borrow at their discretion. Thus, when they required credit, they drew from the limit and when they were in surplus, they paid back the excess cash to the bank. This system meant that the corporates did not have to enforce a discipline of cash management on them. Instead, the onus of cash management was on the banks. As a result, there was a lack of interest from the non-bank players, especially the corporates, in a market for short-term funds. The availability of the on tap treasury bills (at a fixed yield of 4.6 per cent) was the other factor responsible for the absence of a market for short-term funds. With the gradual introduction of a loan system in place of the cash credit system from April 1995, the onus of cash management was shifted back on the corporates. This, along with the discontinuation of the on tap treasury bills from April 1997, has led to a substantial improvement in the breadth and depth of the market for short-term funds.

Check Your Progress 2

Note: i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the unit.

1) Unlike many other central banks, why is it difficult for the RBI to adopt price stability as the single objective of monetary policy?

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2) What is the distinction between direct and indirect instruments of monetary policy?

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3) Explain how the ad-hoc treasury bills were used as a mechanism to automatically monetise the fiscal deficit.

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4) State whether following statements are True or False.

   i) LAF is used to control liquidity shocks of a temporary nature, while OMOs are used to control liquidity shocks of a relatively more enduring nature. ( )

   ii) CRR and SLR are indirect instruments of monetary policy. ( )

   iii) OMOs and repos are direct instruments of monetary policy. ( )

   iv) Automatic monetisation of Central Government deficits through ad-hoc treasury bills had been discontinued since 1997-98. ( )

   v) All interest rates except the one on savings bank deposits are now market determined. ( )

14.4 LET US SUM UP

Over the period, as the financial markets developed, inter-linkages between the various segments of the financial markets (short-term debt market, long-term debt market, foreign exchange market) grew. This created increasingly more conducive conditions for the use of indirect instruments. Consequently, the reliance on direct instruments has been gradually reduced, and indirect instruments have increasingly been resorted to by the RBI to fine-tune the financial markets. In the emerging scenario, OMO (in the form of outright sale/purchase of dated Government securities) has become the primary tool to absorb liquidity shock of a relatively enduring nature. Liquidity Adjustment Facility (LAF) operated through daily repo/reverse repo transactions has been the major tool to regularise short-term liquidity shocks.

14.5 EXERCISES

1) Examine the role and significance of a well-developed money market in the process of economic growth of a country.

2) Discuss the different constituents of money market in India. Also examine the mechanism of RBI intervention in the money market.

3) Briefly explain the objectives of monetary policy in an economy. Also discuss the instruments and targets of monetary policy as practised by the Reserve Bank of India.

4) Make a critical evaluation of the monetary policy of the Reserve Bank of India.

14.6 KEY WORDS

Bank Rate: Bank Rate is the rate of interest, announced by the Central Bank, at which it rediscounts securities of commercial banks like discounted bills of exchange, treasury bills.

CRR (Cash Reserve Ratio): Commercial banks are required to maintain a portion of their total deposits (demand deposits, i.e., savings bank deposits and current account deposits, and time or fixed deposits) in cash and/or as deposit with central banks. This is known as Cash Reserve Ratio (CRR). According to the Banking Regulation Act, 1949, RBI can vary the CRR between 3 per cent and 15 per cent. This is a direct instrument of monetary policy used by the RBI until the late-1990's. An increase (decrease) in the CRR reduces the funds available to the banks for lending, and tightens (loosens) the liquidity conditions in the economy.

Money Supply: Aggregate money supply is argued to be the major determinant of inflation in an economy with a stable demand for money function. The most commonly used definitions of money supply are M_1 (or narrow money), M_2 and M_3 (or broad money). Narrow money, as the name suggests, is a narrow definition in the sense that it includes two most liquid monetary assets – currency with the public (currency notes and coins in circulation plus cash in hand with banks) and deposit money of the public (demand deposits with banks plus other deposits with RBI). Since demand deposits (or checkable deposits – basically savings bank deposits and current account deposits) can be converted into cash at any point of time, this is almost as liquid as currency with the public. M_2 includes M_1 and post office savings bank deposits. M_3 (or broad money) is defined as M_2 plus time deposits with banks.

Reserve Money: Reserve money is the reserves maintained by commercial banks against their deposits and the currency in circulation (with non-bank public). All deposit-taking commercial banks are required to maintain a percentage of their deposits with the Central Bank. This percentage is known as statutory reserve ratio (or Cash Reserve Ratio or CRR in India).

Reserve Money = Required Reserve + Excess Reserve + Currency in Circulation.

Central banks can directly control the reserve money through various instruments at its disposal. Changes in reserve money lead to changes in money supply (M_3) through the operation of the money multiplier.

Scheduled Commercial Bank: A commercial bank whose name appears in the Second Schedule of the Reserve Bank of India Act, 1934, is known as Scheduled Commercial Bank.

SLR (Statutory Liquidity Ratio): Commercial banks are required to maintain a certain percentage of their total demand and time liabilities in liquid assets like approved securities (mostly securities of the Central Government and State governments and bonds issued by the PSUs), gold and cash (apart from CRR). According to the RBI Act, the RBI can vary this ratio

between 25 per cent and 40 per cent. Currently, this ratio is fixed at 25 per cent. In the past, especially up to the early 1990's, RBI has used the SLR requirement extensively as a monetary policy tool.

All India Financial Institutions (AIFIs): All-India Financial Institutions (AIFIs) comprise five All-India Development Banks (AIDBs), viz., Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India Ltd. (IFCI), ICICI Bank Ltd., Infrastructure Development Finance Corporation (IDFC), Small Industries Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI, erstwhile Industrial Reconstruction Bank of India or IRBI), three Specialised Financial Institutions (SFIs) viz., IVCF (erstwhile Risk Capital and Technology Corporation or RCTC), ICICI Venture (erstwhile TDICI) and Tourism Finance Corporation of India (TFCI) and three investment institutions viz., Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and General Insurance Corporation (GIC).

14.7 SOME USEFUL BOOKS

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Machiraju, H.R. (2004); *Indian Financial System*, Vikas Publishing House, New Delhi.

Reddy, Y.V. (2002); *Parameters of Monetary Policy in India*, Lecture delivered by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at the 88th Annual Conference of The Indian Econometric Society at Madras School of Economics, Chennai on January 15, 2002.

Reddy, Y.V. (2005); *Monetary Policy: An Outline*, Presidential Address by Dr. Y.V. Reddy, Governor, Reserve Bank of India circulated in the Annual Conference of Andhra Pradesh Economic Association, on February 12, 2005 at Vishakhapatnam.

Reserve Bank of India, *Report on Currency and Finance*, 2001-02, 2003-04.

14.8 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Go through Section 14.2 carefully and get your answer.
2) See Sub-section 14.2.7
3) i) True
   ii) False
   iii) True
   iv) True
   v) False
   vi) False

Check Your Progress 2

1) If inflation would have caused primarily by monetary factors, monetary policy could pursue the single objective of price stability. But that is not the case in India. In India, inflation is caused by monetary factors

UNIT 16 PUBLIC FINANCE AND FISCAL POLICY

Structure

16.0 OBJECTIVES

This unit is concerned with Public Finance and Fiscal Policy. After going through this unit, you will be able to:

- *explain* the concept of fiscal policy;
- *describe* the working of fiscal policy in India;
- *discuss* the finances of Union Government;
- *examine* the finances of State Governments;
- *analyse* the issues and concerns of India's fiscal policy, and
- *relate* the remedial measures for improving the financial health of the government.

16.1 INTRODUCTION

These days there is hardly any economy in the world which is not regulated by government budget decisions and public policy. The Government imposes taxes and spends on various public works and programmes. The Government also borrows and invests in various economic activities. There are many public sector undertakings producing various types of goods and services. All these activities of the government influence private production, employment, consumption, saving and investment. There are many people who believe that the Central and State Governments in India are overdoing their economic activities. They impose too much taxation. Public undertakings are run inefficiently. The Government is also borrowing too much. On the other hand, there are many who believe that the Government is not doing enough to promote growth and social justice. There is a lot more the Government could and ought to do: for instance, remove poverty and develop backward regions. As we go along this unit, we will review the role played by the Government in the Indian economy and you can yourself form your own views about the success and failure of the Government budget decisions.

16.2 CONCEPT OF FISCAL POLICY

Public Finance is a part of study of Economics. It borders on the fields of government and political science. Public finance is the study of the financial activities of governments and public authorities. It describes and analyses the expenditures of governments and the techniques used by governments to finance these expenditures. Public finance analysis helps us to understand why certain services have come to be supplied by government, and why governments have come to rely on particular types of taxes. There is both a normative and a positive side to public finance.

Fiscal policy aims at using its three major instruments – *taxes, spending and borrowing* – as balancing factors in the development of the economy. According to *Arthor Smithies* fiscal policy is a policy under which government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment. Fiscal policy consists of the use of taxes, government spending, and public debt operations to influence the economic activities of the community in desired ways and is concerned with the allocation of resources between the public and private sectors and their use for the attainment of stability and growth. Although the effects of fiscal policy are extensive, they are particularly measurable in areas such as employment, price stability, savings and investment, and the balance of payment. The prime aim of such a policy is to maintain a high level of employment without inflation.

16.2.1 Objectives of Fiscal Policy

Formulation of fiscal policy presumes the identification and clear recognition of the *institutional aspects of government finance, such as tax system, their incidence and shifting, budget formulation and execution and financial management*. The focus of budgeting is on the attainment of efficiency in the allocation of resources within the public sector and is influenced at each stage by the goals of fiscal policy. The changes in government income or expenditure have been designed to affect the level of activity in the economy as a whole. An understanding of the fiscal policy is essential for gaining proper perspectives on the different aspects of

budgeting. In the recent years importance of fiscal policy has increased due to economic fluctuations. Fiscal policy is an important instrument in the modern time.

The budgetary fiscal policy can, play a key role in the process of economic development by *(i) mobilising additional resources, (ii) maintaining economic stability, (iii) allocating resources into socially necessary lines of development, (iv) reducing extreme inequality in income and wealth, and (v) providing the necessary incentives to the private sector for its healthy growth*. The fiscal policy thus has not one goal. It has a *multiplicity* of *goals*. Hence, they cannot be achieved by any one set of policies. A disaggregated approach will be needed. There may be conflicts between allocation and stabilisation goals. In the context of economic growth, the fiscal policy has to be so framed as to avoid an inflationary pressure in the economy.

16.2.2 Implications of Fiscal Policy

Fiscal policy is so wide-ranging that selection of a combination of differing objectives is both complex and controversial. Supply-side economists argue that economic activity is quite sensitive to changes in tax rates, particularly the highest marginal rates. In today's global economy, tax policy is not conducted in a vacuum. Taxes can influence the choices of both business and labour. The decisions that the government makes over fiscal policy can have important implications for business. What causes governments to ignore budget deficits in some circumstances and not in others? Business also need to understand what effect a change in fiscal policy is likely to have on aggregate demand. In recent decades, the ratio of government expenditure to GDP has increased in most countries. In many countries its present level can not be financed by ordinary sources of revenue. As a consequence, many governments have been compelled to borrow heavily. If a country borrows too much money, it has to pay a great deal of interest every year in order to service that debt.

The greatest obstacle to proper use of fiscal policy is that changes in fiscal policy are necessarily bundled with other changes that please or displease various constituencies. The same is true for a tax cut for some favoured constituency. The problem of making good fiscal policy in the face of such obstacles is, in the final analysis, ***not economic but political***. There are many practical limitations or drawbacks to the actual working of the fiscal policy. The objective of fiscal policy in modern society cannot be promoted in isolation. It has to be coordinated to monetary, credit and debt policies to be effective. The questions relating to the manner of financing deficit or disposing of surplus in a budget have close relationship with monetary and credit policies.

Monetary and fiscal polices can be best understood in the context of the events that shape them. Such an analysis can assist in choosing policies that improve rather than disrupt short- and long-term economic performance. Of particularly interest are the circumstances and policies surrounding the recent recession.

16.3 SIZE OF GOVERNMENT IN INDIA : COMBINED RECEIPTS AND DISBURSEMENT

The combined expenditure of Central, State and Union Territory Governments has increased more than 1947 times from Rs. 918 crores in 1950-51 to Rs. 17,88,195 crores in 2009-10. Aggregate tax revenue of the Centre, States and Union

Territories has also increased more than 1918 times from Rs. 627 crores in 1950-51 to Rs. 12,02,412 crores in 2009-10. *This, however, not a correct comparison because it does not adjust for inflation*. The combined expenditure of the Central, State and Union Territory Governments as a ratio to GDP has increased from less than 10 per cent in 1950-51 to around 32 per cent in 2009-10. The ratio of combined tax revenue of all governments to GDP has increased from 6.6 per cent to 16 per cent between these years. In India, current expenditures are assuming a larger proportion of government expenditure, mainly driven by consumption expenditures and transfer payments *viz.*, interest payments and subsidies. On the other hand, social sector expenditure comprising mainly, education, medical facilities, public health, family welfare and sanitation showed a steady deterioration, particularly in the 1990s. The deterioration in the allocations under social sector is sharper in the Centre than in States. Another adverse consequence of the deterioration in revenue/GDP ratio has been the discretionary cut back in public investment in productive sectors raising the issue of the *quality of fiscal adjustment* and this may have been an important factor underlying the resurfacing of fiscal pressures over the second half of the decade.

Taking the budgetary position of the central government and states together, one finds that the combined expenditure as a per centage of GDP rose from 26.8 per cent in the 1990s to 27.4 per cent in 2007-2008. The subsequent two years show a sharp rise in expenditures, with the budget estimates for 2009-2010 showing expenditure at almost 32 per cent of GDP. This has been a consequence of a sharp increase in public expenditure in the run up to the general elections of 2009-2010. Total receipts have also shown a similar increase from around 26 per cent to roughly 31 per cent from the 1990's to 2008-2009. Over 60 per cent of receipts are accounted for by revenue receipts (both tax and non-tax). The rest has come from capital receipts of which the two major components have been debt capital receipts (mainly borrowings) and disinvestment.

The share of the central government's capital receipts in GDP was just above 6 per cent until 2000-2001 and thereafter increased until 2003-2004. Since then, it declined reaching 3.6 per cent in 2007-2008. Debt capital receipts have been the major contributor to capital receipts. The contribution from disinvestment has been about 1-2 per cent of capital receipts in the post-reform period. Disinvestment was the highest in 2003-2004.

Check Your Progress 1

1) Explain the concept of fiscal policy

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2) What are the objectives of fiscal policy?

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3) Point out the importance of fiscal policy.

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4) Write three important features of size of government of India in relation to revenue and expenditure.

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16.4 FISCAL POLICY IN INDIA

The objective of economic policy during the *1950s and 1960s* was mainly to *increase the growth rate of the economy* through increasing public investment and overall economic planning. Taxation was used as an instrument for reducing private consumption and for transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Furthermore, taxation policy was geared towards achieving the economic objectives of: (i) promoting employment through grant of tax incentives to new investment; (ii) reducing inequality through progressive taxes on income and wealth; (iii) reducing pressure on balance of payments through increase of import duties; and (iv) stabilising prices through tax rebate in excise duties on consumption goods. *Fiscal policy during the 1970s* consciously focused on *achieving greater equity and social justice* and both taxation and expenditure policies were employed towards this end. Accordingly, income tax rates were raised to very high levels, with the maximum marginal rate of income tax moving up to 97 per cent and, together with the incidence of wealth tax, it even crossed 100 per cent. Over the years, in addition to the commitment towards a large volume of developmental expenditure, *the Government's expenditure widened to include rising subsidies*. Large interest payments on growing debt and downward rigidity in prices further contributed to increased current expenditure. Current revenues, on the other hand, were less buoyant leading to the emergence of *sizeable revenue deficits* in the Central government budget *from 1979-80 onwards*.

During the 1980s, Indian public finances were in a state of disarray with the fiscal pattern destabilising the relationship between the economy and the budget. This resulted in persistently large deficits which were seemingly intractable. *Considerable fiscal deterioration took place during the 1980s and eventually became unsustainable*, though the growth rate did rise significantly with enhancement in public investment in infrastructure. During this phase, expenditure of the Government was seen as an instrument having a bearing upon aggregate demand, resource allocation and income distribution. The Government sought to reduce its deficit through tax increases. Customs duties were hiked to augment revenue and to protect domestic industry. There was a *structural change in the government budgets during the 1980s*. The emergence of *revenue deficit* in 1979-80 in the Centre's Budget continued to enlarge during the 1980s, raising concerns over the rising public debt and interest payments and the consequent constraint on the

availability of resources for meeting developmental needs. The 1980s witnessed a steady increase in market borrowings along with an increase in Reserve Bank's support to such borrowing, thus compromising monetary policy.

Broadly, during the first 30 years of independence, between 1950 and 1980, the fiscal deficits of both the Central and the State Governments were not excessive. There was a significant deterioration in the fiscal situation in the 1980s, accompanied by large and automatic monetisation of government deficits.

16.4.1 Fiscal Policy Reforms since the 1990s: Tax Structure and Policy

Taxation is perhaps the most controversial element of public policy. The Indian tax system, like that of any other country, has developed in response to many influences — political, economic and social. It has not been constructed by an *ideal* economist in line with the optimal requirements for a *good* tax structure. Indian tax structure over the years has been evolved by pressures from two contradictory forces: (a) revenue maximisation; and (b) social and economic reforms through taxation. Revenue maximisation has generally gained ascendancy over reform objectives in actual tax policy. The reform motive, however, has asserted in the recent years, though not always in a positive way. Tax receipts, which contribute the bulk of the central government revenues, fell sharply in the period following the introduction of the reforms in 1992. This was the result of the *rationalisation of the tax structure*. The tax reforms initiated since 1991 were part of the structural reform process after the 1991 economic crisis. *The Tax Reforms Committee (TRC)* concentrated on finding a suitable framework to reform both the direct and indirect tax structure. The committee recommended two major reforms on direct taxes — one was the simplification and rationalisation of the direct tax structure (*The Chelliah Committee,* 1992); the other was to introduce a *service tax to widen the tax base* (*The Chelliah Committee,* 1994).

The 1992 reforms radically altered the composition of tax revenue at the central level. Direct taxes as a per centage of GDP rose from 2.0 per cent in the 1980s to 6.5 per cent in 2008-2009. *Corporation tax* now is the major source of direct tax followed by income tax. Estate tax, wealth tax, gift tax etc. are very tiny amounts. These taxes are levied on richer income and wealth classes to bring equity in the tax structure. Agriculturalists pay only two types of direct tax: land revenue and agricultural income tax. Together, they now account for about 7 per cent of total direct tax revenue. *Direct taxes are, therefore, paid basically by non-agriculturists*. Revenue maximisation through indirect taxes has to be evaluated in relation to inflationary pressures generated by higher indirect taxes. In the recent years, there has been a reform in the indirect tax structure. Until recently, *indirect taxes*, particularly excise duties, were levied on most intermediate goods used as inputs. However, this rise in the proportion of direct taxes was offset by a reduction in central indirect tax revenues as a per centage of GDP from 7.9 per cent to 5.3 per cent over the same period. The government also *introduced a service tax in 1994* in line with the recommendations of the Chelliah Committee. Until then, the service sector had been totally left out of the tax net. Starting with three services, viz., namely telephone, stock broking, and insurance services, the coverage has progressively widened over the years with about 119 services having been brought within the ambit of taxation till 2011. Initially with a levy of taxes on three services of 5 per cent. The tax rate was revised to 10 per cent in 2004-05, 12 per cent in 2006-07, and further reduced to 10.3 per cent in 2009.

Collections from service tax have shown a steady rise from 1994–1995 (0.2 per cent of GDP) to 2008-2009 (1.1 per cent of GDP). However, in 2008-2009, they accounted for only 10.4 per cent of the total tax receipts of the central government. The government now intends to move to a *goods and services tax (GST) regime*, which will replace state-level VAT and CENVAT. This will mark a major step in unifying the tax regime across the country and do away with tax arbitrage that currently disturbs investment decisions. At the state level, fiscal health depends both on revenues from state taxes as well as constitutional and other transfers from the central government. These transfers are accounted for in a state's revenue receipts.

There is no doubt that fundamental changes in the centre's tax structure were introduced in the 1990s. *Systematic and comprehensive efforts to reform the tax system in India started only after market based economic reforms were initiated in 1991*. Centre's *tax reforms included*: (i) Customs duties were scaled back, (ii) individual and corporate income tax rates were significantly reduced, and (iii) a rationalisation of the excise tax structure eliminated the distortionary inclusion of inputs from the tax base, (iv) the number and level of rates reduced, (v) revamping of tax administration, and (vi) computerisation. Tax rates in respect of *personal income tax* were simplified considerably to *just three slabs* of 10, 20 and 30 per cent in 1997-98. The financial assets were excluded from wealth tax and the marginal rate was reduced to one per cent. The corporate income tax has also undergone significant changes.

The *indirect tax structure* has undergone marked changes during the last two decades or so. Both domestic excise duties that were levied on manufactured goods and customs duties on imports have undergone considerable simplification and rationalisation. Besides reduction in the number of rates, the tax has been progressively reduced. These were further merged into a single rate in 2000-01 to be called a *Central VAT (CenVAT)*, along with three special additional excises (8, 16 and 24 per cent) for a few commodities. The CenVAT rate of 16 per cent has now been reduced to 14 per cent. *Custom duties* have undergone far reaching reforms. The reform of custom duties started in 1991-92. The number of major duty rates was reduced from 22 in 1990-91 to 4 in 2003-04. There are some items outside these four rates, but *90 per cent of the custom duties are collected from items under the four rates*.

At the beginning of the economic reforms process in 1991-92, the ratio of direct and indirect taxes in gross tax revenue was 22.6 per cent and 74.8 per cent respectively. As part of the larger economic reforms, the reforms in the tax structure effected through a gradual and sequenced reduction in the rates of duties in both customs and excise together with the increase in the levels of income resulted in a gradual shift in the composition of taxes. As a result in 2004-05 – the year when the FRBM regime was operationalised – the ratios of direct and indirect taxes were 56.1 per cent and 43.3 per cent of gross tax revenue; in 2009-10, the ratios were 58.6 per cent and 39.5 per cent respectively.

16.4.2 Tax Preferences/Tax Expenditure

The main objective of any tax system is to raise revenues to fund Government expenditures. The amount of revenue raised is determined to a large extent by *tax bases and tax rates*. It is also a function of a range of measures – *special tax rates, exemptions, deductions, rebates, deferrals and credits – that affect the level and distribution of tax. These measures are sometimes called tax*

preferences. They have an impact on Government revenue (i.e. they have a cost) and reflect the policy choices of the Government. Tax preferences may be viewed as subsidy payments to preferred taxpayer such implicit payments are referred to as *tax expenditures* and it is often argued that they should appear as expenditure items in the Budget. In this context, the basic issue is not one of tax policy but one of efficiency and transparency — *programme planning* requires that the policy objectives be addressed explicitly; and *programme budgeting* calls for the inclusion of such outlays under their respective programme headings. Tax expenditures are spending programmes embedded in the tax statute.

The importance of tax incentives in a tax system cannot just be brushed aside. It has to be appreciated and accepted as an established situation that a tax system cannot be totally free from such provisions. What is needed is a balanced well laid-out policy and to ensure that these benefits accrue only to those sections of taxpayers, who deserve and the economy as a whole benefits from these. There should be no *adhocism* in giving these and decisions in this regard should not be influenced by lobbying by some quarters at the cost of teeming millions in the country. Hence, the revenue loss, cannot be avoided what is needed is well-planning to achieve the objectives for which these are designed. Also, a study regarding areas where revenue loss occurs consequent to these should be made to find out whether the objectives sought to be achieved by foregoing tax is realised. The Income-tax Act, *inter alia*, provides for tax incentives to promote savings by individuals; exports; balanced regional development; creation of infrastructure facilities; employment; donations for charity and rural development; scientific research and development; and the co-operative sector. *Accelerated depreciation* is also provided as an incentive for capital investment. Most of these tax benefits can be availed of by both corporate and non-corporate taxpayer.

Revenue loss from exemptions and deductions. The total magnitude of tax revenue forgone due to exemptions/incentives/deductions in the central government tax system has been estimated (by the Finance Ministry itself) to rise from Rs. 4.14 lakh crore in 2008-09 to Rs. 5.02 lakh crore in 2010-11. A liberal estimate of the amount of additional tax revenue which could have been collected by the union government in 2009-10, if all exemptions/incentives/deductions (both in direct and indirect taxes) had been eliminated, stands at a staggering 8.1 per cent of GDP. Not all kinds of tax exemptions/incentives/deductions can be eliminated; however, there could be a strong case for removing those exemptions which are benefiting mainly the privileged sections of population. The income tax foregone for 2009-10 and 2010-11 for corporations was Rs. 72,861 crore and Rs. 88,263 crore; for non-corporate assesses Association of Persons, Body of Individuals (AOPs, Firms and BOIs) Rs. 4,845 crore and Rs. 436 crore; and for individuals Rs. 40,197 crore and Rs. 45,222 crore respectively. For the corporate sector because of such exemptions and deductions, the effective rate of tax was 23.53 per cent as against the statutory rate of 33.99 per cent. For non-corporate assesses (Firms, AOPs and BOIs, the effective rate of tax is 20.78 per cent vis-à-vis statutory rate. For individuals, the effective rate of tax in their cases has not been worked out because of (i) composition of taxpayers in the category of salary and non-salary taxpayers, and (ii) progressive rate of taxes.

16.4.3 Tax-GDP Ratio

Table 16.1 shows the overall tax structure in India. You can see that the tax-GDP ratio has recorded an impressive rise from 6.6 per cent in 1950-51 to 16.0 per cent in 2009-10. The rise is accounted for by the growth of the indirect tax-GDP

ratio, which now stands at 10.03 per cent. Direct tax-GDP ratio has increased over the long-run and now stands at 5.97 per cent. *Direct taxes are increasing in importance*. The Indian experience also shows how long it takes for fiscal reform to be effective, and hence the importance of consistent policy over a long period. Although tax-GDP ratio in India is now fairly high, it is still lower than many other developing countries and most industrial countries. India is, therefore, not a very highly taxed nation, although the indirect tax burden on the common man is on the high side. As a part of reform of the taxation system, indirect taxes, excise duties as well as custom duties, were reduced substantially from their earlier high levels and this impacted the magnitude of indirect tax collections. The tax-GDP ratio reflects beneficial impact of the rationalisation of the direct tax structure on the revenues. Growth provides the base for rise in tax-GDP ratio of the country.

The combined ratio of tax to gross domestic product (GDP) of the central and state governments fell to a seven-year low of 14.73 per cent in 2010-11. Experts attributed it to larger expansion in the size of the economy, which is delivering a lower ratio despite a rise in tax proceeds. Total tax revenue increased 17.5 per cent to Rs. 11.6 lakh crore in 2010-11, compared to 7.9 per cent growth a year before. Despite this, the tax to GDP ratio fell, reflecting the combined effect of economic growth and inflation. This signifies that the economy is growing at a healthy rate. While the direct tax to GDP ratio was 5.84 per cent in 2010-11 (budget estimates), a four year low, the indirect tax to GDP ratio was 9.25 per cent. The break-up of the ratio into the Centre's and states' numbers reveal the Union Government tax-GDP ratio, after devolution of tax funds to states, was at an eight-year low of 6.8 per cent. Within this category, the direct tax-GDP ratio was 3.76 per cent and the indirect tax-GDP ratio was 3.02 per cent. These figures are not comparable with earlier years. While the structure of the economy has moved decisively in favour of services which *contribute the highest amount to GDP, but major part of it is unorganised; hence, they do not yield so much tax*. The rise in service tax-to-GDP has not been as sharp. On the other hand, the states' tax-GDP ratio is at a 12-year low of 5.25 per cent. Of this, the direct tax-GDP ratio was just 0.12 per cent during 2010-11. However, states do not have direct tax as their major source of revenue; the major bit comes from indirect taxes. After states switched to a value added tax (VAT) regime from one based on sales tax from April, 2005, the indirect tax-GDP ratio rose to 5.86 per cent during 2005-06. A year after, the ratio again rose to 5.98 per cent. After that, it has been steadily coming down. Their indirect tax-GDP ratio was at a 11-year low of 5.13 per cent. However, if the absolute indirect tax kitty is taken into account, states' revenues rose 87 per cent after they shifted to VAT. This is a staggering figure, compared to just 4.4 per cent annual in the preceding five years (*Business Standard*, August 19, 2011).

India compares very poorly with the tax-GDP ratios of developed nations. For instance, the tax-GDP ratio for the *UK* is 34.3 per cent, for *Germany* 37 per cent and about 24 per cent for the *US*. Despite the plethora of schemes to increase the tax base, tax-to-GDP levels are even below what they were in the pre-reforms period the tax-to-GDP ratio was 15.93 in 1989-90. Most of the decline has been due to the fall in the central tax collections, where the tax-to-GDP ratio has moved down by 2.42 per centage points from 11.9 per cent in 2007-08 to 9.48 per cent in the budget estimates for 2010-11. The fall has been marginal for the states' taxes. While industry accounts for about 28 per cent of GDP, excise duties account for 1.82 per cent of GDP; services comprise 58 per cent of GDP but the

service tax-to-GDP ratio is only about one per cent. All of which underscores the urgent need for a *combined goods and services tax (GST)* (*The Financial Express*, August 20, 2011).

Table 16.1: Share of Tax Revenue in GDP (per cent).

	1950-51	1960-61	1970-71	1980-81	1990-91	2000-01	2009-10
1) **Central Taxes**	4.2	6.0	8.0	9.7	10.11	8.80	10.29
a) Direct	1.8	2.0	2.2	2.2	1.94	2.97	5.84
b) Indirect	2.4	4.0	5.8	7.5	8.17	5.83	4.45
2) **State Taxes**	2.3	3.0	3.8	4.9	5.29	5.55	5.71
a) Direct	0.6	0.7	0.3	0.2	0.22	0.16	0.13
b) Indirect	1.7	2.3	3.5	4.7	5.08	5.39	5.58
3) **Total Tax Revenue**	6.6	9.0	11.8	14.6	15.4	14.52	16.0
a) Direct	2.4	2.7	2.5	2.4	2.15	3.41	5.97
b) Indirect	4.2	6.3	9.3	12.2	13.25	11.11	10.03

Source: Government of India – Indian Public Finance Statistics (Various Issues)

16.5 EXPENDITURE PATTERN AND POLICY

Public expenditure is incurred to provide public goods and services. In national accounting, a distinction is made between government final expenditure on consumer and investment goods and services and transfer payments. Public expenditure may also be divided between *plan and non-plan*, *developmental and non-developmental*, *and revenue* and *capital*. One may also divide public expenditure *into civilian and defence* and also between ministries, sectors and so on. All these classifications are necessary to know specific effects of public expenditure on the economy. Finally, one may divide public expenditures by institution: Central Government, State Governments and Local Authorities. Relatively more expenditure of the Central Government may reflect greater centralisation in decision-making of expenditure.

At the central level, average government expenditure stood at 17.6 per cent of GDP in the 1980s. The share fell by 1.6 per cent immediately after the reforms, mainly because of the macro-economic stabilisation programme that followed the 1991 balance of payments (BoP) crisis. However, a sharp rise in salaries and pensions following the acceptance of the *Fifth Pay Commission* report in 1996-1997 pushed the expenditure level back to the 16-17 per cent level the following year. After the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) was passed, central government's total expenditure fell from approximately 16 per cent to 14 per cent of GDP over the next two years. However, this expenditure control was achieved by cutting down capital expenditure sharply while revenue expenditure showed only a marginal decline. Thus, the composition of government expenditure, which has always been a matter of concern, remains unchanged with revenue expenditure accounting for about 80 per cent of total expenditures. Public capital expenditure as a per centage of GDP declined from an average of 6.2 per cent in the 1980s to 3.6 per cent in 2004-2005 and further to 1.8 per cent in 2008-2009. By contrast, revenue expenditure, which was 11.4 per cent of GDP during the 1980s, rose to 12.2 per cent in 2004-2005 and to 15.1 per cent in 2008-2009.

A major weakness of government finances has been the inability to curtail revenue expenditures. Fiscal stabilisation carried out in the 1990s included both extensive tax reform as well as expenditure reforms. The total expenditure of the Central Government has declined from 17.9 per cent of GDP in 1990-95 to 14.7 per cent in 2004-07. Both revenue and capital components of expenditure have declined during this period. Most importantly the share of capital expenditure in total expenditure declined sharply from 25.7 per cent in 1990-98 to 17.0 per cent in 2004-07, though this happened partly because of the cessation of loans from the central government to states, which were classified as capital expenditures. However, the decline in capital expenditure does suggest some moderation in public investment over the period, which has contributed to the lower than desirable growth in infrastructure investment since the mid 1990s.

Table 16.2 : Combined expenditure of the Centre and the States (Revenue and Capital) as a per cent of GDP.

	1990-91	2000-01	2009-10 (BE)
1) Developmental Expenditure (including loans and advances: gross)	14.7	12.0	14.5
2) Non-developmental expenditure (including Loans and advances: gross)	12.5	14.3	14.2
3) Total expenditure* (2+3)	27.2	26.3	28.7
Of which:			
i) Education, family welfare, medical and public health, and water supply and sanitation	4.4	4.3	4.6
ii) Agriculture and allied Services	2.1	1.7	2.2
iii) Defence	2.7	2.4	2.3
4) Total expenditure net of lending	26.8	25.9	28.7

*Excludes self-balancing item and transfer to funds

Non-developmental expenditures are those which do not contribute directly to economic development, like *defence and administrative expenses*. *Interest payments* and certain categories of subsidy are also included in non-developmental expenditures. Both developmental expenditure and non-developmental expenditure have risen faster. It is also noteworthy that defence expenditure increased substantially. Most of the increase in defence expenditure has grown after 1960.

As in the mid-1990s, the reason for the sharp rise in revenue expenditure in 2008-2009 has been the implementation of the recommendations of the *Sixth Pay Commission* Report and measures such as the *debt waiver on farm loans and subsidies*. *Interest payments*, which account for over 30 per cent of revenue expenditure, stood at about 4 per cent of GDP until 2004-2005. However, these came down to 3.6 per cent in 2005-2006 and continued at the same level until 2008-2009. This, however, was not really the result of a reduction in borrowings but rather an effect of softening of interest rates. The other major item of revenue expenditure has been *subsidies*. Budget data do not indicate the actual expenditure

on subsidies because several subsidies are hidden in the production of intermediate goods and services and the quantum of subsidy at the stage of final consumption of goods or services is not clearly known. Explicit government budgetary *subsidies like those on food, fertilizers, and petroleum products* are only a small portion of the total subsidy.

Expenditures at the state level exhibit a trend similar to those at the central level. From an average of roughly 15.5 per cent of GDP in the 1980s and 1990s, the total state-level expenditures rose to nearly 18.0 per cent in 2009-2010. An increase in revenue expenditure also accounted for the rise in states' expenditure. Capital expenditure has shown a more fluctuating trend. In the immediate post-reform period, there was a sharp drop in states' capital expenditures. This was an unhealthy development, because by reducing capital expenditure to achieve fiscal balance, they had effectively compromised on building the infrastructure capacity needed to promote growth.

The relative shares of the Centre, on the one hand, and of States and Union Territories, on the other, in total public expenditure, have not varied much in the last three and half decades. *The Centre spends about 55 per cent and States and Union Territories together spend about 45 per cent*. The pattern of expenditures of the Centre and the States vary. The Centre spends all of the defence expenditure. States spend more on agriculture and rural development. The Constitution has allocated items of public expenditure into three categories: (a) exclusive to Centre – defence, external affairs, nuclear energy, etc., (b) exclusive to States, and (c) concurrent, in which both Centre and States can spend.

Check Your Progress 2

1) Point out the four important points of working of fiscal policy in India during pre-economic reform period (before July 1991).

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2) Explain the rationale behind fiscal policy reforms since July 1991.

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3) What do you mean by tax preferences/tax expenditure?

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4) Highlight the main features of tax GDP ratio in India.

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5) Distinguish between Development and Non-development Expenditure. Give three main heads of expenditure in each category.

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16.6 FISCAL IMBALANCE

As a result of the concerted efforts to restore fiscal balance through *tax reforms, expenditure management, institutional reforms and financial sector reforms in the first half of the 1990s*, there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP during the period 1991 to 1997. However, during the period 1997 to 2003, (i) there was a reversal in the trend of fiscal consolidation, (ii) the cumulative impact of industrial slowdown, (iii) *fifth pay commission* award, and (iv) a lower than expected revenue buoyancy culminated in fiscal deterioration. This deterioration in the Indian fiscal position happened at an inopportune time when there was fiscal improvement the world over and India was trying to globalise.

The structural transformation in the economy also impacted upon the tax revenue flows. The structural character acquired by revenue imbalances during the 1990s has been a critical factor underlying the rigidity of *fiscal imbalances* and explains as to why *fiscal correction* has not been durable during the 1990s. Thus, the *combined fiscal deficit* at the end of the decade was the same as at the beginning at around *nine per cent* of the GDP. The reduction in the fiscal deficit at the Centre which has also followed a *zig-zag* path has been off-set by a rise in the fiscal deficit of the States. Both plan expenditures and capital expenditures of the central government have fallen to levels of about 4 per cent of GDP or less now. *Interest payments now constitute the largest component of expenditure of the central government*. The key area for action in correcting this fiscal imbalance is related to rising debt servicing obligations of the central government. With the government running a revenue deficit since the early 1980s, *all government and public sector investment has come from resources borrowed by the central government*. In the presence of no returns from such investments, debt service payments are bound to become an increasing burden.

It has not been easy to undertake expenditure reforms. Much of government expenditure is non-discretionary. With increasing fiscal deficits, interest payments have formed a significant proportion of government expenditure. The government wage bill and pension obligations are also non-discretionary. Defence expenditures cannot probably be reduced. *Subsidies on food, fertilizer and oil have proved to be difficult to reduce*, despite various attempts at targeting them better. As a

proportion of GDP, however, they are now lower than they were in the early 1990s, though there are now renewed pressures for higher subsidies because of the recent increases in the prices of each of these items. Overall, *the correction in total central government expenditure has essentially come from reductions in capital expenditure*.

The most important reform measure was the passing of the fiscal responsibility legislation in 2003. In the years following the enactment of the *Fiscal Responsibility and Budget Management Act*, the fiscal deficit declined from 4.5 per cent of GDP in 2003-04 to 2.6 per cent in 2007-08. In 2009-10, the fiscal deficit was 6.9 per cent (revised estimates). This increase could be partially attributed to the *fiscal stimulus package* of the Government of India. The health of the central government's finance did deteriorate on account of the *stimulus package*. The target fiscal deficit for the years 2011-12 and 2012-13 is 4.8 per cent and 4.1 per cent of GDP, respectively. If the recommendations of the *Thirteenth Finance Commission* are implemented and its suggestions are followed, then one can foresee an improvement in the state of the fiscal deficit. To begin with, the Commission recommended a '*calibrated exit strategy from the expansionary fiscal stance of 2008-09 and 2009-10*'. It has suggested that the revenue deficit of the Centre should be eliminated and the objective should be to have a revenue surplus 2014-15 onwards. In the context of *combined debt of the Centre and states, the Commission has suggested a target of 68 per cent of GDP to be achieved by 2014-15*.

Table 16.3: Deficit indicators of Centre, States and combined finances.

(Per cent of GDP)

Item		1980-85 (Avg.)	1985-90 (Avg.)	1900-95 (Avg.)	1995-00 (Avg.)	2000-04 (Avg.)	2004-07 (Avg.)	2009-10
Centre	RD	1.0	2.4	3.0	3.1	4.1	2.3	5.1
	GFD	5.9	7.7	6.3	5.5	5.5	3.9	6.3
	PD	3.8	4.5	2.2	1.1	0.9	0.1	3.1
States	RD	-0.4	0.2	0.7	1.6	2.4	0.5	0.7
	GFD	2.8	3.0	2.8	3.4	4.3	2.9	3.3
	PD	1.9	1.6	1.1	1.4	1.5	0.4	--
Combined	RD	4.8	5.2	2.9	2.5	6.5	2.9	5.7
	GFD	7.2	8.9	7.8	7.7	9.4	6.8	9.5
	PD	0.6	2.7	3.7	4.7	3.1	1.1	--

RD: Revenue Deficit; GFD: Gross Fiscal Deficit; PD: Primary Deficit

Source: Handbook of Statistics on Indian Economy, 2006-07, RBI, Economic Survey, 2010-11.

16.7 FISCAL REFORMS AND FINANCES OF STATE GOVERNMENTS

State governments are responsible for most public expenditures for the provision of social services. Further, they are responsible for most infrastructure services except for telecommunications, civil aviation, railways and major ports. *They are also responsible for law and order*. Thus a deterioration in the state's ability to invest is very serious for human development and hence for internal security, in addition to the harmful effects on economic growth. In the case of state governments, capital expenditure fell during the late 1980s as well. But, just as in the central

government, *the main problem lies in increasing debt service payments.* Similarly, other committed expenditures such as pensions have also been rising.

The decline in central transfers and the increase in the average cost of debt have adversely affected the fiscal scene in the states, particularly during the 1990s. Primary expenditure, which is net of interest payments, as a per centage of GDP showed a trend of a decline indicating the shrinking of the fiscal space of the states. If we exclude the other committed expenditures, viz., wages and salaries and pension payments, the residual of expenditure available for both operation and maintenance and much needed fresh investment for the provision of various publicly provided services under social and economic services is on the decline. All the *committed expenditures*, viz, interest, wages and salaries and pension constituted around 65 per cent of the total revenue receipts in 1994-95, which increased to more than 85 per cent in 2002-03. *Although, the aggregate fiscal scene depicts a gloomy picture of state finances in India in general, the severity of the fiscal crisis differs widely across states in terms of the levels and quality of the fiscal deficit, debt-servicing obligations, the level of the debt stock and the fiscal space.*

The four years from 2004-05 were a remarkably good period for the finances of State Governments. All this was, of course, facilitated by high economic growth, which proved to be the proverbial tide that lifted all boats. From 2008-09, there has been *a setback to the fiscal turnaround process*. The Reserve Bank of India's '*State Finances: A Study of Budgets*' shows that the number of States with revenue deficits increased from just four in 2007-08 to six in 2008-09 and 11 in 2009-10. Even for 2010-11, nine States are budgeted to have revenue deficits; the figure may well go up in the revised estimates. State debt has grown faster than output and many states have budgeted for revenue deficits. The picture is worse in States such as *West Bengal*, where interest payments, salaries and pension payments consume over two-thirds of revenue receipts, as against roughly a third in *Tamil Nadu* and *Maharashtra* or less than a fifth in *Chhattisgarh*. Reverting to the path of fiscal consolidation is important not only to create headroom for more purposive, growth-promoting investments, but also to complement the reforms already underway at the State-level.

At the state level, while individual State Governments appointed Committees from time to time to reform their tax structure, there was *no systematic attempt to streamline the reform process even after 1991* when market oriented reforms were introduced. The pace of tax reforms in the States accelerated in the latter half of the 1990s. A uniform *Value Added Tax (VAT)* has now been adopted by all the States in place of the existing sales tax. The Central Government has played the role of a facilitator for successful implementation of VAT. The initial experience with implementation of VAT has been encouraging.

It has been observed that economic liberalisation since the early 1990s has unleashed competition among sub-national governments, and this has brought to the fore the central role of incentives in ensuring sound fiscal practices at all levels of governments. Some of the important changes in sub-national fiscal policy worth highlighting in this context are: (i) the introduction of state level *Fiscal Responsibility and Budget Management (FRBM)* Acts to institutionalise rule-based fiscal control by 14 states; (ii) incentivising the system of transfers to fiscal performance by successive finance commissions, (iii) increasing reliance on state-specific discretionary transfers through memorandum of understanding (MoU) with the

central government, (iv) sub-national adjustment lending based fiscal correction in selected states at instances of multilateral institutions, primarily the Asian Development Bank and World Bank, and (v) reforms related to macro-economic policy changes. The primary objective of state level fiscal reform programmes is to achieve fiscal consolidation through revenue enhancement, reducing and restructuring of expenditure, reducing subsidies and power sector loss and thereby overall fiscal restructuring and consolidation. The current system for the financing of investments by state governments in India is clearly unsustainable. *The problem has essentially arisen because of the lack of a link between borrowing and end use of expenditures in capital investment*. There has been a rise in the issue of state government guarantees for their public sector entities enabling them to borrow directly from the market. The budgeted gross fiscal deficit of the states as a per centage of total state gross domestic products is 3.2. That is twice the actual level of 2007-08.

The most important conclusion is that *the rule-based fiscal policy adopted by States improved fiscal discipline*. Therefore, the challenge before State governments is to *revert to fiscal consolidation*. The higher devolutions recommended by the *Thirteenth Finance Commission (FC)* will benefit State finances. Factors likely to have significant implications for fiscal consolidation at the States' level include implementation of *Goods and Services Tax (GST)*, States' own efforts towards mobilising non-tax revenues and prioritisation and rationalisation of expenditure. For credible progress towards fiscal consolidation, States need to amend their FRBM Acts. *The strengthening of State Finance Commissions* is *essential to ensure the allocation of resources to local bodies, keeping in view their developmental role for the purpose of inclusive growth*.

A comparative profile of debt accumulation of individual states shows that those with lower per capita income and a high level of fiscal deficits have a higher debt stock. A higher stock of debt implies a larger interest burden and consequently lower fiscal space available for primary expenditure. *It can be observed that in the post-economic liberalisation era in India, fiscal reforms at centre and the financial sector reforms have adversely affected sub-national finances*. Thus, in the past two decades, the sub-national fiscal space has been shrinking in the face of an increase in the cost of borrowing. Corrective measures are required to widen the fiscal space for developmental fiscal needs. The public debt continues to exhibit signs of unsustainability.

Given the general neglect of state finances, RBI is right to be concerned about the decline in the states' own tax revenues. The central bank is right to suggest that state governments need to: (i) augment their revenues through improved tax collections, (ii) measures to check under-valuation of property to improve collections under stamp duty and registration fees, and (iii) phase out exemptions under sales tax. Non-tax revenue can be a major source of budgetary receipts for the state governments if *proper attention is paid towards pricing of the services*. Its importance is now being realised in the context of bridging fiscal deficits of the states and the heavy financial requirements for upgrading and modernising basic infrastructure. On the non-tax front, the RBI report says, the states' *own non-tax* revenue, at around 10 per cent of the total revenue receipts, is low by international standards. The states have been advised to increase their reliance on non-tax revenues by: (i) levying appropriate user charges such as time-bound revision of water supply tariffs, introduction of user charges in health, education and veterinary services, and (ii) cost recovery from social and economic services.

What is needed is *political will at the state level*. Union Finance can play a leadership role by setting an example in fiscal responsibility that states can follow.

Table 16.4: Combined Fiscal Stance of the Central and State Governments (As a per cent of GDP).

	1980-1989	1990-1999	2000-2001	2009-2010 BE
Total Expenditure	28.8	26.8	28.3	31.9
Revenue Expenditure	20.7	22.3	24.6	27.1
Interest Payments	3.1	5.0	5.9	5.6
Capital Expenditure	8.1	4.5	3.7	4.8
Capital Outlay	-	-	-	4.5
Loans and Advances	-	-	-	0.3
Total Receipts	27.1	26.0	28.5	31.4
Revenue Receipts	18.9	18.1	18.0	21.6
Tax Revenues	15.0	14.6	14.5	17.5
Direct Taxes	2.5	3.2	3.8	7.4
Indirect Taxes	12.5	11.4	10.7	10.1
Non-Tax Revenues	3.9	3.5	3.5	4.2
Capital Receipts	6.2	7.9	10.5	9.8
Debt Capital Receipts	-	-	-	9.6
Non-Debt Capital Receipts	-	-	-	0.17
Disinvestment Proceeds	-	0.2	0.1	00
Revenue Deficit	1.8	4.2	6.6	5.5
Gross Fiscal Deficit	8.0	7.7	9.5	10.2
Gross Primary Deficit	4.9	2.7	3.6	4.6

Notes: BE: Budget Estimates
Source: RBI (various issues)

16.8 PUBLIC DEBT IN INDIA

The gap between government total expenditure and current revenue is financed almost wholly through various types of borrowings which add to the public debt. Public debt is outstanding Government borrowing at a point of time, usually calculated at the end of the financial year. Public debt is the stock corresponding to the flow of Government borrowing. Borrowings can be made from both *internal and external sources*. As Government borrowing increases, public debt rises. So long as the debt financing is kept within a limit there is no problem. Debt financing, however, beyond a limit, causes several problems. As the volume of debt rises, the burden of interest payment and repayment of debt increases, and a stage may come when the Government is unable to service the debt i.e., interest payments become a big burden. There are other problems of debt financing.

Between 1950-51 and 1990-91 the gross debt of the central (internal, external and other liabilities) has risen from Rs. 29 billion to Rs. 3114 billion, i.e. by 106 times. As a per centage of GNP, the increase has been from 32 per cent to 68 per cent. This growth is phenomenal.

The public debt as a ratio to GDP has risen phenomenally over time, and in particular in the eighties. There is no doubt that public debt is now matter of serious concern. The high level of fiscal deficits both at the Centre and the States led to debt accumulation over the period resulting in a rise in the debt to GDP ratio. The combined debt-GDP ratio of Centre and States was about 81.0 per cent during 2004-06. Following the impact of fiscal responsibility legislations at both the centre and the states, the combined debt-GDP ratio has come down to 73.8 per cent in 2007-08. Of the overall Central Government debt, about 92 per cent is internal debt and 8 per cent is external debt. Internal debt largely consists of market loans in the form of dated securities which are contracted through auction. Most of the dated securities (97 per cent) are fixed coupon and only the balance 3 per cent are floating rate bonds. The weighted average maturity of these dated securities is about 10 years while the weighted average interest rate is about 7.8 per cent per annum. The outstanding debt of State Governments is estimated at 26.3 per cent of the GDP for 2009-10. THFC has recommended limiting the combined debt of the Centre and States to 68 per cent of the GDP by 2014-15.

If debt is used for financing investment projects, then that would generate more income in future and the country would benefit. If debt is instead incurred for unproductive expenditure, say paying higher salary to defence and police and general administration personnel, then it does not generate any income and, consequently, creates a repayment problem. Until recently, the Government was using debt exclusively to finance capital expenditure. But in the recent years the Government has started using debt to finance its current expenditure. This is a clear violation of norms of prudent fiscal policy.

16.8.1 India's External Debt

External debt consists of bilateral loans or loans from international monetary agencies. *The growth of external debt is a far more serious matter than internal debt. External debt directly affects a country's balance of payments position, trade flows and currency valuation*. Since the very significant fiscal imbalance in the 1980s had also contributed to the 1991 balance of payments crisis. The fiscal crisis of 1990-91 was caused by the phenomenal increase in the external sector deficit. In fact external debt is all the more difficult since the principal amount and interest repayments keep accelerating with increasing debt as also due to currency devaluation. This in fact forms a vicious circle and the country falls into a debt trap which threatens its sovereignty in the long.

The major developments relating to India's external debt as at end-March 2011 are that India's short-term debt to total external debt ratio rose to 21.2 per cent in 2010-11, the highest in at least five years. The status report on external debt for 2010-11 showed that the short-term debt to foreign exchange reserves increased to 21.3 per cent. The rise in short-term debt is considered riskier as it needs to be repaid from foreign currency reserves in a shorter duration of time. However, the external debt to gross domestic product (GDP) ratio fell to 17.3 per cent in 2010-11. *The composition of external debt is worrying*. The increase in short-term debt to total external debt is not a welcome development because short-term external debt is considered riskier than long-term external debt. *However, India's*

external debt is not yet in the danger zone. At the end of March 2011, India's short-term debt was $65 billion and India's total external debt stood at $305.9 billion. The share of commercial borrowing in total external debt has increased from 19.7 per cent at the end of March 2005 to 28.9 per cent at end-March 2011. The changing composition of debt in favour of commercial borrowing, however, is also an indication of a maturing market economy and the increasing role that the corporate sector is playing in sustaining the high growth rate.

India's debt indicators compare well with other indebted developing countries. According to the World Bank's latest Global Development Finance report, which contains external debt numbers for 2009, India's position was fifth, after China, Russia, Brazil and Turkey, in terms of absolute debt stock among the top 20 developing debtor countries. In terms of ratio of external debt to gross national income, India's position was the fifth lowest. Although external debt as a ratio to GDP is not very high, one must not underestimate it, because India's foreign exchange reserves and export earning capacity are also very low. The repayment of this moderate amount of external debt may also, therefore, be a problem in future. *One does not have to panic over the growth of debt as such. What matters ultimately is the use of debt.*

16.9 ISSUES AND CHALLENGES IN FISCAL POLICY FORMULATION

The fiscal situation in India is worrisome. The self imposed rule based *fiscal correction* at both the national and sub national levels has to be consolidated and carried forward. Achievement of the current objectives will still leave the combined fiscal deficit in India at around 10 per cent of GDP, and somewhat higher if the off budget items are also taken into account. The main challenges are:

i) In the fiscal policy area, the success achieved in revenue buoyancy through tax rationalisation and compliance has to be strengthened further. Large proportions of the self employed remain outside the tax net; thus continued *strengthening and modernisation of tax administration* now needs to be emphasised, relative to further reforms in tax policy in terms of relative emphasis. This would enable *further shifts in tax revenue toward direct taxes from indirect taxes*, thereby aiding greater economic efficiency. At the state level also, the move to *VAT* has provided *very significant tax rationalisation*, and emphasis now needs to be put on its administration. In this sphere, the next step of reform would, of course, be the proposed move towards a unified *Goods and Service Tax (GST)* regime encompassing the Centre and the States. The foundations of an efficient fiscal regime in India have, therefore, been achieved.

ii) *Rakesh Mohan* has observed that the *expenditure side*, containing the *subsidy* burden has proved difficult, although its increase as a proportion of GDP has been contained. The second issue on the expenditure side relates to the funding of public investment particularly related to *infrastructure*. The acceleration of economic growth to the next level is therefore likely to lead to an enhancement of government spending as a proportion of GDP, which would be consistent with the experience of other countries as their per capita incomes increased. This then is the main *challenge confronting Indian fiscal policy: how to provide for an enhancement in public expenditure while continuing fiscal consolidation and reducing fiscal deficits further*.

iii) It is clear from experience that the mere passing of the legislation will not bring about fiscal discipline. *First of all*, it is necessary for the government, *not just the Ministry of Finance, to take responsibility for fiscal discipline for stable macro-economic management and political motivation; no legislation can ensure this*. *Secondly*, it is necessary to evolve an institutional mechanism not only to monitor but also to ensure the *participation of all spending departments in implementation*. The experience with the implementation of the *Fiscal Responsibility and Budget Management Act (FRBMA)* has raised some important questions on its efficacy. *Without the government's willingness, institutions cannot ensure fiscal discipline*.

iv) Professor *TCA Anant*, has suggested that the expenditure cuts must come in those sectors/areas that do not constitute productive spending by the government. This is often harder than cutting expenditure in productive areas, i.e., public investment. This is because much of the *non-productive spending fulfills certain populist aims of the government*. A big deficit puts upward pressure not just on inflation but also on interest rates. That is a double whammy for growth, something the government must avoid. Even after taking out *interest payments and subsidies*, there would still remain a large lump of inflexible expenditure comprising salaries, pensions, and staff overheads. These might be declining as a proportion of GDP but that does not tell the whole story. In several states, in departments such as health and education which are staff-intensive, as much as 95 per cent is spent on the wage bill, leaving precious little for other things.

v) *The central government has resorted to a fiscal system of high fiscal deficits on a consistent basis over the last 30 years*. Non-productive committed current expenditures rise giving rise to higher and higher revenue deficits. This leads to yet higher and higher borrowing levels. The main sufferer in this process is government *capital expenditure* in both *social and infrastructure facilities*. The continued high levels of public borrowings also have an effect on the rest of the economy through prevalence of high interest rates. *The key objective of fiscal reform has to be a reduction in debt service payments*. This has to be achieved by a progressive reduction in public debt and through higher revenues. The emerging debt position is not a sustainable one. The policy implication is that India should strive to reduce primary deficit or achieve a primary surplus, raise the growth rate, and reduce the interest rate.

vi) The *Expenditure Commission* has delineated *selected subsidies* that should be scaled back. An increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit. In other words, the governments of the centre and the states combined are borrowing resources amounting to a 10th of national income every year: about a *half of these resources are being borrowed to defray current expenditures on items such as wages and salaries*. The current trend is such that before long almost all borrowing will essentially finance current expenditure leaving almost nothing for investment. A mere reduction in tax rate may not persuade people to pay tax unless there is fear that, tax evasion would be heavily penalised. *Higher tax revenues can be achieved only through buoyancy and expansion of the tax base*.

vii) It is also clear that the *problem is largely structural*. Much of the problem has arisen from the failure to correct the *structural problems of proliferating*

subsidies and transfers. Despite fundamental changes in the overall rate structure, by and large the tax base has not been enlarged. *The tax base has not expanded in structural terms*. Even smaller taxes such as the *capital gains tax, wealth tax, gift tax, and inheritance tax at the central level, or the property tax, motor vehicles tax, professions tax and the like at the state level, were typically replete with exemptions reflecting the perception of the tax instrument as useful for attaining various social and economic goals*. Not only was the number of taxes affected by exemptions very large, but the conditions under which the exemptions were applicable were very complex. This problem with the overall tax structure continues at present. Though the rate structure was improved, the *leakages in the tax base have not been plugged*. There are significant areas in which tax administration needs to be strengthened. In the area of Direct Taxes, administration should be restructured in favour of functional departmental classifications. In Customs and Excises, computerisation has helped administration.

viii) We cannot forget the fact that out of the 120 crore population, only 3.36 crore pay taxes in India. One should not forget that even this number has been achieved only by lowering the tax rates, resulting in better compliance for the last several years. *The number of tax evaders, and the money invested in tax havens, increases because of the high tax rates only*. What we have to do now is to reduce tax rates and increase the tax base, enforce compliance and insist on penalties for evaders. We cannot compare India with France, Germany or the US, where the majority pay taxes and there is also a well-set social security system. *The need of the hour is to include more in the tax net, by reducing the tax rates and enforcing compliance*. This will definitely pay off by higher collection as well. However, we can think of a super tax for incomes above a substantially-higher threshold.

India is currently facing a *mix of complex fiscal problems*, pertaining not only to the central government but also at the level of state governments. These manifest themselves in: *(a) an apparent inability of the central government to rein in its fiscal deficit, (b) a rise in state governments' fiscal deficits resulting in a consolidated general government (centre and states combined) fiscal deficit of almost 10 per cent of GDP, and (c) their unwelcome implications for the medium term sustainability of public debt*. The key challenge involves balancing between public interventions and maintaining market confidence in the sustainability of public finances. This will involve focusing policy attention on *removing some of the structural bottlenecks* on raising the potential GDP growth rate. Essentially, this will imply efforts to improve the investment climate for both domestic and foreign investors, remove entry barriers to corporate investment in education and vocational training, improve the delivery of public goods and services, and expand physical infrastructure capacities, including a major effort to improve connectivity in the rural regions. Infrastructure is a key binding constraint on India's growth and the government should take up long-term projects to improve infrastructure facilities. The government also needs to step-up investment in *human capital development through increased spending in areas such as primary education, primary health, and research and development. Investment in human capital will help achieve inclusive growth, and furthermore such expenditures should be considered as part of capital expenditure rather than as revenue expenditure (which is how they are categorized now) since they yield a return in the long-term by way of inter-generational equity and economic growth*. These measures

will constitute the package of second-generation structural reforms and will enable the Indian economy to climb out of the downward cyclical phase.

16.10 INDIA'S FISCAL POLICY (1950-2012): AN OVERVIEW

In this section, an attempt is made to analyse and examine how far the multiple objectives of Indian fiscal policy have been realised. Fiscal strategy or policy refers to the budgetary policy of the government in power. It includes tax policy, expenditure policy, public debt policy and any other policy which is implemented through the budget. In the wider sense of the term, it also includes related policies such as monetary policy in so far as it is interlinked with the public debt management policy of the government. After independence and with the advent of planning, fiscal policy was accepted as an important tool in the armoury of government to direct the allocation of national resources in the desired direction. In a developing economy like India, fiscal policy came to be used as a principal instrument of resource mobilisation and allocation. Besides, the objectives of fiscal policy came to be identified as promoting economic development, maintaining economic stability and achieving social justice. Achieving economic development implied certain specific policy measures. It encompassed diversion of increased income in the private sector (from going to private consumption) to savings in the public sector, an increase in public sector saving by the expansion of public sector activities and generating surpluses by public enterprises. Accumulation of capital by the government through the generation of public savings was a major objective of state capitalism conceived in Indian Planning. Fiscal Policy was used to achieve this objective. Economic stability in the Indian context implied mostly controlling inflation. Employment and output stability were taken for granted. Economic stability was supposed to be maintained by levying taxes, particularly indirect taxes, so as to reduce the real consumption or real demand. Thus, on the one hand, there was an attempt to divert increased income from consumption through direct taxes as well as high rates of indirect taxes, and at the same time public expenditure was proposed to be allocated in such a way as to create not only infrastructural facilities required for private and public sector production activity but also for creating productive capacity for goods required in the economy.

Social justice or equity was attempted to be achieved through progressive taxes like wealth tax, gift tax, capital gains tax, income tax, estate duty and so on. However there was not much transfer of payments to the poor in the form of negative income tax or in the form of unemployment and old age benefits. All that the government did was to formulate anti-poverty programmes which were introduced only during the Fourth Five Year Plan period. After realising the failure of the '*trickle down*' process several target group-oriented programmes were initiated which provided financial assistance, both subsidy and loan, to the small and marginal farmers, unemployed youth artisans, agricultural labourers, and to petty shop-keepers, to make them economically viable.

The initial years of India's planned development strategy were characterised by a conservative fiscal policy whereby deficits were kept under control. The tax system was geared to transfer resources from the private sector to fund the large public sector-driven industrialisation process and also cover social welfare schemes. However, growth was anaemic and the system was prone to inefficiencies. Indirect taxes were a larger source of revenue than direct taxes. The government authorised a comprehensive review of the tax system. *Kaldor* found the system inefficient and

inequitable, given the narrow tax base and inadequate reporting of property income and taxation. *The Direct Taxes Enquiry Committee of 1991* found that the high tax rates encouraged tax evasion. In the 1980s, some attempts were made to reform particular sectors and make some changes in the tax system. But public debt increased, as did the fiscal deficit. Triggered by higher oil prices and political uncertainties, the balance of payments crisis of 1991 led to economic liberalisation.

The reform of the tax system commenced with direct taxes increasing their share in comparison to indirect taxes. In consonance with the tax reform plans, the sources of central government revenue shifted from indirect taxes towards direct taxes. The rising revenues from tax administration reforms and expenditure control resulted in the deficits being brought under control. The Planning Commission in the approach paper to the 12th Five Year Plan (2012-17), while projecting the Centre's fiscal resources, envisages an average fiscal deficit of 3.25 per cent of GDP for the entire plan period. In the future, the focus would probably be on bringing in new tax reforms and better targeting of social expenditures.

The first-generation reforms consisted of rationalisation of the direct and indirect taxes levied by the Centre, broadening of their bases, and lowering of the statutory rates. It is very difficult to identify the level of tax rates which make tax payers honest without reducing the flow of tax revenue to the government. The second-generation reforms were the replacement of state sales taxes by the value-added tax (VAT). While these reforms resulted in improvement in tax compliance and provided a significant boost to tax revenues, they were limited to legislative changes and the rich dividends that could be reaped by having a modern, IT-savvy and taxpayer-friendly tax administration remain unrealised. A facilitative tax administration is dependent on simplicity of the tax laws, infrastructure for tax administration, harmonisation and integration of laws and procedures across the country.

India's tax-to-GDP ratio is 15 per cent (of which the Centre's share is 10 per cent). Before the financial crisis of 2008, it was 17.7 per cent (of which 12 per cent was central taxes). The problem in India is not with rates; it is with coverage. Hence the familiar criticisms — only 35 million pay income tax, a service economy which accounts for more than half of GDP delivers less than one per cent of GDP as tax, and so on. Perhaps reduced evasion comes with the better systems associated with a higher order of development. More people come into the organised sector, and evasion becomes more difficult because transactions leave a trace. That automatically raises the tax-GDP ratio, without tax rates having to go up. The other way is to use information networks to detect evasion. For instance, nearly half of the income tax collection comes from just two per cent of taxpayers (715,000 people who report a taxable income of Rs. 8 lakh or more). Yet, household surveys show that the number in that income bracket should be twice as large. If they could be traced, imagine what it would do to tax revenue.

The Fiscal Responsibility and Budget Management Act has not helped much in preventing the monetisation of fiscal deficit. Much of our fiscal deficit is made up of the revenue deficit, a perverse stimulus to consumption in an economy that needs investment. In its present form, the arithmetic and the analytics of the Union budget revolve around five deficit numbers: *fiscal, revenue, primary, monetised, and current account deficits*. All of them came to the fore ever since the budget was transformed into a fiscal policy document after fiscal stabilisation in 1991. The flaw is not just economic. It reflects a fundamental problem in the political strategy of the Government. Usually multiple objectives of public policy are contradictory, and the policy would serve one at the cost of others. Given the current global

context and the domestic macro-economic situation, the budget needs to be reinvented as a public expenditure policy document. The emphasis should be on how the government intends to strengthen the legitimacy and effectiveness of policy-making in areas that are causing a systemic crisis. These done, the fiscal deficit along with its associates will take off itself on a sustainable basis.

Tax expenditure or revenue foregone on account of various tax concessions was an astounding Rs.4,82,432 crore, or more than the entire fiscal deficit for 2009-10 . Back in 1974, the late *Dr Amaresh Bagchi* had argued eloquently against tax sops. The same sentiment finds place in a research paper by the National Institute of Public Finance and Policy (NIPFP) which makes a strong case against riddling the tax regime with exemptions. The fewer the tax incentives, the less is the discretionary space available to tax administrators and less is the scope for corruption. If the objective is to have a transparent, efficient and feasible tax administration, then the tax structure should have low rates, a broad base, few exemptions and few incentives. Rather than allowing more concessions – whether by way of exemptions or rebates – what we need to do is rationalise the system of taxation so that the incidence of tax on income is same regardless of the source. Unfortunately, even as most economists decry tax exemptions and concessions in pursuit of a variety of objectives through tax policy, it is a fact that special interest groups in every country secure them under the guise of one social objective or another. *In India, the tax policy has been made to pursue a variety of objectives such as promoting savings, encouraging exports, enabling balanced regional development, creating infrastructure, promoting scientific research, encouraging employment, enabling gender equity, protect the elderly, promote small cars versus large and so on and so forth besides raising revenue and promoting equity*. Surely, these objectives are worthy, but they should be pursued through other policy instruments rather than loading the tax policy with them. Pursuit of multiple objectives through the tax policy complicates the tax system and provides enough scope for evasion and avoidance.

The most important initiative to change the sentiment is to *undertake fiscal consolidation measures*. In pursuance of objectives, both the Central and State Governments provided subsidy. Therefore, systematic reforms in tax system and expenditures, particularly in the subsidy regime, are unavoidable. The subsidy bill has been a major contributor to the slippage. Clearly, *tax expenditures in India are large and it is necessary to phase them out in the interest of revenue, efficiency and horizontal equity*.

The reforms for achieving simplicity in tax laws and their harmonisation are an ongoing process and the *goods and services tax (GST) is aimed at addressing this objective*. The GST, if based on the flawless design recommended by the 13th Finance Commission, could well be the 4G reform. Pending its implementation, governments should focus on archaic, inefficient and ineffective tax administration. Critical ingredients of a modern tax administration are automation and standardisation, quality taxpayers' services, avoidance of tax disputes and their quick resolution. The most pivotal reform among these is a more effective use of information technology. While India has made considerable progress in terms of computerisation, it is still very basic. The significant role that IT can play in comprehensive automation and integration of processes, minimising discretion by officials, data capturing and analysis for guiding policy decisions and for enhancing taxpayer services, has not been tapped in full measure. A stable and efficient tax administrative environment would also spur foreign investments, crucial for India's economic growth.

An important issue in calibrating tax reforms in a federal system is the need to coordinate the reforms at the national and sub-national levels. Tax harmonisation, both vertically among different levels of government and horizontally among governmental units within each of the sub-national levels, is important from the viewpoint of minimising the collection cost, compliance cost and distortion cost. However, the very principle of fiscal federalism entails the choice to the States to vary their public service levels and tax rates. The State tax system is beset with a number of shortcomings. The States have found it politically difficult to levy taxation of agricultural incomes, except in the case of a few plantation crops, and this has opened up avenues for evasion and avoidance of taxes on incomes. Every effort should be made to minimise rate differentiation from the viewpoint of reducing distortions in the economy. *But these are political decisions and compromises are unavoidable*.

The fiscal situation in the country surely is a cause for serious concern. Difficult situations warrant drastic remedial measures. Hopefully, the government will evolve a workable strategy and muster sufficient political will to implement harsh measures well before the policy paralysis comes into play due to electoral reasons. The fiscal arithmetic has gone terribly wrong. Of course, there is always scope for clever financial engineering to camouflage the size of the fiscal deficit. As such, *there are concerns about the quality of fiscal adjustment*. The problems of the Indian fiscal deficit are not of recent origin. Way back in the 1980s, Reports of Finance Commissions as well as those by the Comptroller and Auditor General (CAG) had emphasised the need for reining in government borrowing. It is argued that the government should have unfettered freedom to meet manifold exigencies such as increased food, fertilizer and petroleum subsidies.

Using fiscal strategy for promoting economic development with social justice and for maintaining economic stability, the Indian experience has not been a total success. No doubt, in the field of mobilising government savings, this strategy has achieved partial success. It has however failed, to a large extent, in the field of achieving economic equity and maintaining price stability. What is missing in the Indian fiscal strategy is a rational approach to the use of public expenditure and transfer payment for the promotion of the objectives of fiscal policy. The proliferation of subsidies has further widened the economic inequalities by benefiting relatively better-off sections of society, without promoting price stability. These are the lessons which have emerged from our past experience. Let us hope that our planners and fiscal policy makers will learn from past experience.

The monetary and social benefits from Government spending should be assessed at periodical intervals and accountability for any shortfalls in the achievements needs to be fixed. There should be adequate checks and balances to ensure that there exists a proper relationship between investment, production, exports, imports and revenue collections and there is no undue misrepresentation of facts by any agency involved. Usage of subsidies is one area requiring close surveillance and for this the Central Government should have special arrangement, even at a cost, to ensure that subsidy has the desired impact. Information technology should be put to optimum use to strengthen the database and initiate follow-up action. The Budget should aim at capturing all forms of economic activities, particularly under the unorganised sector, and bring them under the information system formally.

Fiscal responsibility is a bit like going to the temple: you want to be there, but there are so many immediate priorities that need attending to. The MGNREGA, Sarva Shikshya Abhiyan; Right to Education and the biggest impact is, of course,

expected from the *Food Security Bill*. Ways and means advances (WMA) which is meant to be used for temporary mismatch in the receipts and expenditure of the government, has been used as a resource. This leads to monetisation of the fiscal deficit.

It could be concluded that fiscal dominance of monetary policy has resurfaced in the Indian context. There is an urgent need to free monetary policy from fiscal dominance to ensure price stability, financial stability and sovereign debt sustainability. *How does one get rid of the fiscal dominance of monetary policy*? It is certainly a difficult task as democracy has a built-in fiscal deficit bias. There is an inflexion point beyond which fiscal deficits militate against growth. Government borrowing is not bad *per se*, but excessive borrowing is. Thus, the following policy options could be considered. *First*, cap the total public debt as a proportion of GDP, including a cap on net market borrowing of the government. *Second*, revisit the public account borrowing, particularly, small savings. *Third*, the revised FRBM Act may include the quality of public expenditure. *Fourth*, the RBI and central government may consider appointing a working group under the institutional framework of Cash and Debt Management Committee to review the entire WMA System.

Check Your Progress 3

1) What do you mean by fiscal imbalance?

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2) Write a note on state of finances of state governments.

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3) Give three reasons for increasing burden of public debt in India.

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4) Point out major developments relating to India's external debt.

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16.11 LET US SUM UP

The fiscal sector consists of the income, expenditure and deficits of the government. As far as the income, expenditure and deficits in the revenue accounts are concerned, there have been very significant changes over the years 1970 to 2000. Both the revenue income and expenditure (as a per centage to GDP) exhibited increasing trends till the mid-1980s, after which they kept falling for the next ten years or so, and have again shown an upward trend after the mid-1990s. Another notable aspect is that till the mid-1980s, the revenue income and expenditure approximately moved together and this resulted in very low (and sometimes negative) values of the revenue deficit. After the mid-1980s, however, the expenditure has been significantly higher than the income leading to high and increasing revenue deficits during this period. The total expenditure (as a per centage of GDP) rises till the mid-1980s, fall for the next decade, and rises again after the mid-1990s. However, the fall after the 1980s is much sharper than that for the revenue expenditure, clearly implying a sharp fall in the capital expenditure during this period. As a result of the sharp decline in capital expenditure, the fiscal deficit shows a downward trend during this period. However, this trend is reversed in the latter half of the 1990s, as total expenditure rises steeply during this period.

A look at the trends and patterns over the last three decades (1980-2010), which span both the pre- and post-reform period, helps us understand the relationship between fiscal expansion and growth in the Indian economy. Along with high external borrowings, a sustained increase in the combined revenue expenditure to stimulate demand, particularly in the services sector, caused the fiscal deficit to rise during the 1980s. As a result, the combined public debt became 56 per cent of GDP on average, with interest payments at 14.6 per cent of revenue expenditure (3 per cent of GDP on average) accounting for a large portion of government revenue expenditure and creating a debt trap in the 1980s. During the first half of the 1980s, these revenue expenditures averaged 18.5 per cent of GDP. In the second half, they rose to an average of 22.4 per cent. The government introduced the *Fiscal Responsibility and Budget Management Act (FRBM)* to control the fiscal deficit. The trends in fiscal deficit were mirrored in the rising public debt levels. The concern now is that the high fiscal deficits suggest an increase in the public debt to above 75 per cent. It could be even higher if GDP growth slows down further. Another aspect of the fiscal scenario that has exhibited changing patterns is the mode of financing of the total expenditure. A debt financed growth strategy during the 1980s and resulted in high levels of debt-to-GDP ratios. This trend was reversed during the first half of the 1990s but there seems to be a return to the high deficit syndrome during 1995-2011.

16.12 EXERCISES

1) Examine the trends in the pattern of Public Revenue and Public Expenditure during the last 30 years.
2) What do you mean by Fiscal Imbalance? What steps have been taken by the Central Government to correct this situation?
3) Examine the various measures taken by the State Governments to improve their finances.
4) What measures will you suggest to improve the working of Fiscal Policy in India?
5) ‘The emerging debt situation is not a sustainable one’. Comment.

16.13 KEY WORDS

Revenue Budget : This consists of the revenue receipts of the government (tax revenues and other revenues) and the expenditure met from these revenues.

Tax Revenues : These comprise proceeds of taxes and other duties levied by the Union.

Non-tax Revenues : These receipts of government mainly consist of interest and dividend on investments made by government, fees and receipts for other services rendered by government.

Revenue Expenditure : This is expenditure for the normal running of Government departments and various services, interest charges on debt incurred by government, subsidies, etc. Broadly speaking, expenditure which does not result in the creation of assets is treated as revenue expenditure. All grants given to state governments and other parties are also treated as revenue expenditure even though some of the grants may be for creation of assets.

Capital Budget : This consists of capital receipts and payments. It also incorporates transactions in the Public Account.

Capital Receipts : The main items of capital receipts are loans raised by government from public which are called market loans, borrowings by government from Reserve Bank and other parties through sale of treasury bills, loans received from foreign bodies and governments and recoveries of loans granted by the Union government to state and Union territory governments and other parties.

Fiscal Deficit : The difference between revenue receipts plus non-debt capital receipts on one side and total expenditure including loans, net of repayments, on the other side.

Primary Deficit : The fiscal deficit minus interest payments.

Balance of Payments (BoP) : Statement of the country's trade and financial transactions with the rest of the world during the year.

Direct Tax : Tax levied by government on the income and wealth received by households and businesses.

Fiscal Policy : An instrument of demand management which seeks to influence the level of economic activity in an economy through the control of taxation and government expenditure.

Indirect Tax : A tax levied by government on goods and services.

Monetary Policy : The tool of macro-economic policy which involves the regulation of money supply, credit and interest rates in order to control the level of spending in the economy.

Public Debt : National debt and other miscellaneous debt for which the government is ultimately responsible. This would include the accumulated debt of nationalised industries and local authorities.

Tax Avoidance : Efforts to avoid paying tax by legal means.

Tax Evasion : Efforts to evade the payment of tax by illegal means.

Tax Base : The total pool which tax authorities can tap when levying a tax.

Value Added Tax (VAT) : A general tax applied at each point of exchange of goods or services from primary production to final consumption. It is levied on the difference between the sale price of output and the cost of inputs.

Good and Services Tax (GST): The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale and consumption of goods and services. The GST is likely to reduce indirect taxes paid on most of the books and services as it would avoid the cascading effect.

16.14 SOME USEFUL BOOKS

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ANNEXURE 1

A Note about GST

Goods and Services Tax (GST) is going to replace CENVAT, state VAT, and service tax. The salient features of GST are the following:

A dual GST model with two separate components. Namely, the central GST (CGST) and state GST (SGST) will be introduced.

Both the central governments and states have to levy GST concurrently on all goods and services other than a small list of exemptions.

Cross-utilisation of input tax credit between CGST and SGST will not be allowed except in case of inter-state transactions (IGST).

GST will have a two-rate structure: a standard rate for most goods and a lower rate for necessities.

A combined rate of 12 per cent (8 per cent for states and 4 per cent for the central government) is seen to be revenue neutral.

The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale, and consumption of goods as well as services at a national level. It will allow a single price for each product across the country. The GST is likely to reduce indirect taxes paid on most of the goods and services as it would avoid the cascading effect. Product prices, therefore, can be expected to fall and ensure growth in demand. In addition, the integration of goods and services taxes will improve tax collections and thereby help increase economic growth. It will also end the long-standing differential treatment of the manufacturing and services sectors. Apart from eliminating cascading effects, double taxation, and other issues, the introduction of GST will facilitate credit on uniform terms across the entire supply chain and across all states. The consensus GST rates may emerge to be 14 per cent. Even this will sharply bring down the incidence of indirect taxes in the economy and release new growth impulses.

Another tax reform that is likely to become effective from April 2012 is the *Direct Tax Code (DTC)* which is designed to greatly simplify the dual tax structure. The intension is to consolidate and comprehensively amend the existing Income Tax Act, 1961 and Wealth Tax Act, 1957 through a single legislation. DTC will achieve this by eliminating distortions in the tax structure, expanding the tax base, and improving tax compliance by introducing moderate levels of taxation. Initial analysis shows that most of these objectives are achievable.

UNIT 26 PRIVATISATION IN INDIA

Structure

26.0 OBJECTIVES

This unit explains privatisation debate in India. After studying this unit, you will be able to answer the following:

- Reasons behind the debate of privatisation ;
- Why are public sector enterprises (PSEs) in India so inefficient ?
- The environment under which PSEs are working in India;
- Rationale behind the privatisation;
- Various techniques of privatisation;
- Identifying areas of privatisation in India;
- Progress towards privatisation; and
- Problems in India's privatisation experience.

26.1 INTRODUCTION

No country in the world has lately been immune from the trend of restructuring of its economy because of a compelling combination of circumstances. India at one time had a huge public enterprise sector. It consisted of nearly 1,300 enterprises, owned and managed by the central government, state and union territory governments, and local governments in the country. These had dominated many sectors of the economy by including: surface irrigation; water supply in rural and urban areas; railways; river transport; ports; postal services; telecommunications; mining (including hydrocarbons and coal); one-third of registered manufacturing (particularly steel, petrochemicals, capitals goods, pharmaceuticals, fertilizers); power generation and distribution; oil and gas production and marketing; air transport; one-third of bus transport; storage; and banking and insurance. As you may be aware, same of these sectors have been transferred to private sector recently.

26.2 REASONS FOR POOR PERFORMANCE OF PUBLIC SECTOR ENTERPRISES (PSEs)

Why are public enterprises in India so inefficient? The answer lies in the *environment that public enterprises in India operate in*, and in effect this environment has on

the *public enterprise managers' incentives* to develop new, better and less expensive products, develop new markets, minimise capital and current costs, and maximize profits. Descriptions which illustrate this environment include: the government's deep involvement in the actual management of public enterprises, with the *concerned administrative ministries'* tendency to function as if they were a kind of super management on top of the Board of Directors; *Parliament's involvement in public enterprises'* affairs in several ways, including through numerous *questions and enquiries* ranging from questions of overall performance and policy issues to the minutest details of *day-to-day functioning*; and expansion of the horizon of *Article 26 of the Constitution* to treat even industrial, manufacturing and commercial public enterprises as '*state*' and thereby subject them to the various obligations that go with such a treatment.

26.3 PRIVATISATION

'*Privatisation*, is a term that is employed to convey a variety of ideas. The idea that it most prominently suggests is '*denationalisation'* (in the sense of transferring the ownership of a public enterprise to private hands). Another idea in vogue is '*liberalisation and deregulation*'; which unleash forces of competition. In this context, the concept of privatisation becomes wider to be understood, not merely in the structural sense of who owns an enterprise, but in the *substantive sense of how far the operations of an enterprise are brought within the discipline of market forces*. For convenience, a distinction could be made between *micro* (roll back as producer state); *macro* (roll back of state as producer, regulator, facilitator, and welfare provider); and *mega* (roll back in all dimensions including non-economic regulations). Micro privatisation referring to producer state essentially deals with public enterprise.

26.4 RATIONALE BEHIND PRIVATISATION

A few factors seem to have brought the issue of privatisation on the forefront. They are as under:

1) The *monopoly* status of public sector enterprises (PSEs) bred inefficiency.

2) *Lack of competitiveness* affects PSEs performance very adversely.

3) *Bureaucracy* was also responsible for poor performance of PSEs. It was certainly not always upto turning such enterprises around.

4) Restructuring of the PSEs by way of privatisation became very *common in developed* countries like UK and U.S.A.

5) A lot of *intellectual discussion and debate* started on privatisation all over the world and pressure of public opinion also exerted influence.

6) Some aid giving agencies even started forcing the pace by linking aid with privatisation.

7) Suggestions from management of public sector enterprises themselves led to fresh thinking towards privatisation.

26.4.1 Arguments in Support of Privatisation

Advocates of privatisation claim that it will lead to an *improved economic performance. The reasons for such a view are* the following:

i) *It will improve the environment* public enterprises operate in and thereby

strengthen their managers' incentives to be efficient. These in turn can contribute to making the Indian economy substantially more efficient.

ii) Privatisation may create conditions for *substantial additional investment*, which may help in generation of a large number of productive employment opportunities, which in turn may contribute to removing poverty.

iii) *Consumers may* gain from privatisation.

iv) Privatisation can be of help in *reforming public enterprises*. These enterprises are engaged in innumerable activities such as manufacturing steel; building ships; generating and distributing electric power; running domestic and international airlines; exploring, producing and refining oil; operating domestic and international telecom network; running hotels; manufacturing polyester film; making condoms; producing fruit pulp and juice; running banks as also life and general insurance and electronic entertainment business; and so on. *Privatisation will allow the government to concentrate on things, which it has failed to do, but which it alone can do.*

v) Privatisation can be of *major help in reducing India's huge public sector deficit*. This can happen in three ways: (a) the proceeds from the sale of public enterprises can be used to finance the public sector deficit, (b) the proceeds can be used to *reduce the outstanding public debt*, both domestic and external; and (c) will reduce the *burden of interest payments* and thereby the deficit.

vi) Privatisation is expected to ensure generation of revenue to finance *social infrastructure and eradication of poverty.*

Check Your Progress 1

1) Give four reasons responsible for poor performance of public sector units in India.

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2) Distinguish between '*micro*' and '*macro*' privatisation.

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3) Mention four reasons in favour of privatisation in India.

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26.5 TECHNIQUES OF PRIVATISATION

Various experts have categorised privatisation into the following techniques:

1) *Public offering of shares:* all or part of a shares of the public limited company are offered for sale to the public as a running concern.

2) *Private sale of shares:* all or part of the shares of a state owned enterprise are sold to a private individual or a group of purchasers in the private corporate sector.

3) *New private investment in a state owned enterprise:* primary share issues are subscribed by the private sector or public.

4) *Sale of Government or state enterprises assets:* the assets of the public sector are sold as private sale instead of shares.

5) *Reorganisation or fragmentation into smaller units:* a holding company with a number of subsidiaries can be privatised separately.

6) *Management/Employee buy out:* the management or the employees acquire the controlling interest in the unit in which the shares are purchased on credits extended by Government or financial institutions.

7) *Lease and management contract:* the ownership remains with the Government while the lessee assumes full responsibility for operations and maintenance. Under management contract, the owner pays for the management and operational control.

26.5.1 Modes of Privatisation

In terms of policy initiative in the Indian context, privatisation is generally conceptualized in three broad ways, viz., *greenfield privatisation; cold privatisation* and *disinvestment or divestiture* (in particular distressed privatisation). The features of each of these modes are summarized below:

1) **Greenfield Privatisation**

Under this method the *barriers to entry*, including '*reservation*' for the public sector are removed and private sector is encouraged to enter. Under this mode actions move on the following lines:

a) removing barriers of entry for the private sector and it is allowed to do economic activity hitherto reserved for public sector;
b) not allowing any new investment or new activities on the part of the public sectors agencies;
c) preferential treatment being given to the private sector for increasing the level of its activities;
d) in enterprises where private and public sectors have been functioning side-by-side, such as the *joint sector*, the relative share of the private sector may be increased.

2) **Cold Privatisation or Proxy Privatisation**

Under this method public enterprise made to behave as private enterprises by:

a) giving financial autonomy to seek financial assistance directly from the bank/capital market;
b) giving autonomy to make investment decisions;
c) entering into a *Memorandum of Understanding (MOU)* for providing freedom to fix prices, output etc.;
d) making subsidies explicit;

e) taking recourse to corporations, i.e., converting a department enterprise into a corporate entity to ensure distancing.

3) **Disinvestment or Divestiture**

Disinvestment or divestiture is effected by *sale or transfer of shares* held by the government directly or through its agencies in enterprises (i.e., public activities organized under enterprise form) to the private sector. When a loss-making enterprise is turned over to the private sector because the government can no longer support and sustain it, this can be termed '*distressed privatisation*.'

It may be mentioned that alternative approaches are possible to analyzing techniques. For instance the techniques can be divided into:

a) privatisation of *financing* (that is charging for government services);
b) privatisation of *production or provision* (contracting out construction and maintenance or giving franchises to private sector);
c) *denationalization* or *load-shedding* (that is sale of shares or assets held by government); and
d) liberalization (removing restrictions and promoting competition).

Check Your Progress 2

1) Mention five techniques of privatisation.

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2) Distinguish between '*greenfiled privatisation'* and '*proxy privatisation'*.

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3) Define the term '*disinvestment'*.

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26.6 AREAS OF PRIVATISATION

Privatisation might be worth trying in a few cases as a means of shedding some unimportant or *low-priority activities* which need not have been in the public sector at all in the first instance; and that it might also be appropriate to try

privatisation, if possible — *as an alternative to closure-in the case of loss-making enterprises* for which a package of remedial measures within the fold of the public sector is not feasible. As for privatisation as a solution to the public sector efficiency problem, it does not really solve but evades the problem: it would surely be much better to try a partial privatisation of style before attempting the privatisation of ownership.

26.7 INDIA'S PRIVATISATION EXPERIENCE

26.7.1 Disinvestment Strategy in Public Sector Undertakings in India

Disinvestment in the state owned enterprises has been adopted by both developed and developing countries during the last two decades as part of market oriented reforms. The process of disinvestment in equity was initiated by the Government of India (GOI) during 1991-92 as part of a package of Public Sector Undertaking (PSU) reform. For framing proper strategies of disinvestment of shares of PSUs, a Committee under the chairmanship of Dr. C.Rangarajan was appointed in 1993 by the Government of India. Further, Government of India constituted a five-member *Public Sector Disinvestment Commission* in August 1994 under the Chairmanship of Shri G.V. Ramkrishna for drawing a long-term disinvestment programme for the PSUs referred to the Commission. The Commission had wide ranging terms of reference and was asked to determine the extent of disinvestment in each PSU, the modalities of disinvestment and the order in which the process would be undertaken. The long-term strategy of the Disinvestment Commission had four objectives : (i) strengthen PSUs, where appropriate, in order to facilitate disinvestment, (ii) protect employees' interest, (iii) broad base ownership, and (iv) augment receipts for the government.

As a broad approach, the Commission was in favour of prior restructuring of the PSUs before disinvestment, based on global experiences that restructuring before disinvestment enhances share value and maximizes share proceeds.

The Commission was in favour of adopting a case-by-case approach in terms of unit specific disinvestment strategy after taking into account various aspects of the units, e.g., industry category, competitive position and profitability. Accordingly, the Commission broadly classified the PSUs into two categories for disinvestment. viz., *the core group and the non-core group*. The PSUs in the *core group* are defined as having a considerable market presence. In these PSUs, as the private sector is yet to mature fully, the public sector disinvestment would be limited to a maximum of 49 per cent for the time being. *The non-core group* industries are defined as the units where private sector players have already made huge investments. With the aim of enhancing the intrinsic value of PSU shares, the Disinvestment Commission recommended that the core as well as non-core PSUs should be restructured prior to disinvestment.

The Commission had made recommendations for a graded delegation of autonomy for three categories of PSUs, namely, '*general autonomy to all PSUs, additional powers to 'moderate performers and additional autonomy to strong performers'*. Further, it had made the following recommendations regarding the policy decisions to be delegated to the Board for greater autonomy of all the PSUs.

1) Professionalising the Board through outside recruitment.
2) Provisions of elected Directors to represent minority shareholders.
3) Selection of top management without having to go to the Appointment Committee of the Cabinet.
4) Rationalising salaries and incentives of top management for attracting talents.

5) Autonomy in price fixation of products and services.
6) Accountability through performance assessment at regular intervals.
7) Setting up of pre-investigation Board for evaluating projects in terms of commercial viability.
8) Strengthening the investor interface by transparent system of information disclosure.

While the above recommended areas of autonomy would apply to all the PSUs, the Boards of *'moderate performers'* among the PSUs would have additional power to transfer assets to a subsidiary and also have freedom of investment decisions subject to certain conditions. The investment limits for these PSUs could be fixed on the basis of the company's turnover and requirement of funds in the medium term. Further, the *'strong performers'* among PSUs have been recommended by the Commission to have power to form joint ventures without prior approval of the Government and have full freedom with regard to investments subject only to the condition that these projects are appraised and financed by banks or institutional lenders or where the total requirements of funds are met from internal accruals.

For granting autonomy, nine well-performing PSUs under the core category have been identified by the Government. These PSUs, popularly known as '*navratnas*', are BHEL, BPCL, HPCL, IPCl, IOC, NTPC, ONGC, SAIL and VSNL. The Union Cabinet has approved the autonomy package for these nine high performing PSUs, accounting for nearly 75 per cent of the profits of the entire PSUs, giving them total freedom to incur capital expenditure, raise resources and enter technology contracts. The Government also announced a package of financial and operational autonomy for 97 profit making public sector enterprises (called *'mini-ratnas'*) other than the '*navrathnas*'. However, the degree of financial freedom to these PSUs will be less than granted to the *'navratnas'*.

For ensuring smooth implementation, the Commission recommended the formation of a *Standing Empowered Group (SMG)*, comprising the Department of Public Enterprises, Administrative Ministry of the PSU along with the CEO of the concerned PSU. The group is intended to provide continuity to the process of disinvestment in various PSUs. However, the Disinvestment Commission has recommended only companies to be disinvested and the mode of disinvestment rests with the Government. The Disinvestment Commission has also evolved guidelines for modality of sale including retailing PSU shares to small investors and employees and selection of intermediaries that would lead to transparent and competitive procedures for disinvestment. The Commission also made specific recommendations for disinvestment in respect of a number of PSUs in its various reports. Thus, the Disinvestment Commission set the ground rules and the basic parameters for disinvestment. We can learn from experience and modify the modalities as we go along.

As part of the country's economic reforms programme, *the Sick Industrial Companies Act (SICA)* 1985 was amended in December 1991 to bring public enterprises under the purview of the *Board for Industrial and Financial Reconstruction (BIFR)*. Consequently, until the end of 1998, 138 cases of sick public enterprises were registered with the BIFR. The BIFR has recommended winding up in 14 of these cases. But none of these public enterprises has been wound up so far. There have been cases of public enterprises whose control and management has been transferred to the private sector, but a substantial proportion of their equity, enough for managerial intervention, has continued to remain in the public sector. *India's privatisation experience also includes cases of complete or true privatisation, under which the control and management of a public enterprise are transferred to the private sector* (though some public sector equity holding, without managerial intervention, may continue).

A major initiative for turning India towards privatisation needs to be launched. In this context certain steps required to be taken are:

i) The people will have to be convinced that, given the extremely high opportunity costs, India cannot afford public sector misadventures in areas like, running hotels, manufacturing polyester film, making condoms and producing fruit pulp and juice). That properly belongs to the private sector.

ii) The Government should announce a properly structured and articulated privatisation policy for India. The policy will need to clearly address at least the following issues: *why privatise*?; *what to privatise*?; when to privatise?; which organization will serve as the nodal agency for privatisation and what will be its composition, powers and responsibilities? What are the institutional mechanisms that will be put in place to gain public enterprise employees' support for privatisation?; and what is the role that India would like foreign investors to play in its privatisation programme?

iii) Privatisation is a difficult process, it involves reconciling the government's political objectives and the business needs of given public enterprise and tap generate efficiencies. It will therefore be absolutely necessary to come up with training programmers designed to equip selected public enterprise managers and government officials in India with the knowledge and skills required for managing the various component of the privatisation process.

iv) The proposed initiative will address the issue of evaluating India's post-privatisation experiences. This will involve rigorous work on estimating the impact of privatisation on: (i) *efficiency and investment*, (ii*) public finance and balance of payments*, (iii) *employment*, (iv*) management practices and strategies*, and (v) *managers' skills, attitudes and behaviours*. Evaluations of post-privatisation experience along these lines may generate ideas that may help India maximize the gains from privatisation.

26.7.2 Problems Associated with Privatisation

Privatisation is not a very easy option. Problems are there and it is always not very easy to overcome them. Some of the major problems (see G.S. Gupta, 1996) are:

1) choice of PSEs for privatisation
2) opposition from employees
3) pricing of assets/or equity
4) extent of disinvestment
5) mode or preference of selling
6) political instability

These problems are very complex and it is not possible to find out an easy way out. The question of permission to be given to foreign investors, particularly in the consumer goods sector, is very difficult to decide. Disinvestment should be done, but in favour of whom? Should it be in favour of financial institutions or to be sold to general public? *If management control is retained by the Government then improvement in efficiency will be doubtful.* Sometimes, it is also feared that owing to political considerations the very policy of privatisation might to reversed. There has been sustained pressure from the organisation of employees against the policy of privatisation and disinvestment.

Check Your Progress 3

1) State in brief the disinvestment strategy as being followed in India.

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UNIT 27 GLOBALISATION OF INDIAN ECONOMY

Structure

27.0 OBJECTIVES

As you go through this unit, you will come to understand and appreciate the implications involved in globalisation of Indian economy. This unit is expected to help you answer the following:

- Is globalisation a reality and has India been able to adopt this;
- Examine the implications involved in the process of globalisation;
- Analyse the impact of globalisation on Indian economy;
- How do different sectors prepare to face the challenge of globalisation;
- What policy measures need to be followed for globalisation of Indian economy; and
- What conditions are required to have the best possible results?

27.1 INTRODUCTION

In recent years there is no special phenomenon that attracts more attention in mass media and in the scientific public than globalisation. For nearly a decade the nation's preoccupation has been with economic reforms. The enthusiasm and the excitement over '*deregulation*', '*liberalisation*' and '*globalisation*' remain undiminished since the time the three buzzwords entered the scene. These terms are frequently used in any general discussion.The common person seldom understands the exact import of these terms but (s) he knows that they imply radical changes in life. The literate population surmises that *liberalisation* indicates a reduction of rigors in laws and procedures to permit more efficient conduct of business while *globalisation* stands for *removal of protective barriers against free flow of trade, technology and investments among countries*. It is also recognised that the insularity and sheltered culture of industry and trade have to give place to a competitive environment, which would demand basic adjustments by the population, be they manufacturers, traders, workers or consumers.

How this change is to be managed with the least pain and with maximum benefit is the major concern. There have been innumerable seminars and workshops on the three related terms in general and globalisation in particular. However, the ideas and the basic vision behind the dominant policy choices made since 1991 have not been

explained in simple terms by those professing to understand the policy choices. Policy makers and seminar speakers often assume that the objectives of globalization are understood by all. They, therefore, dwell on the ways and means to achieve globalization.

27.2 GLOBALISATION AND ECONOMY

Globalisation has some very clear features (K.L. Chugh, 1992). Globalisation puts an emphasis on consumer concern and encourages competition. *It is co-operative venture, where organisations and people complement and supplement each other in the service of the consumer.* It is for this reason, that one now sees the international trend to source raw material from one country, process it in another country and then market it worldwide. As a result, globalisation helps to synergies the roles of each country. Globalisation leads to quality assurance and it is as a guarantee of their quality that manufacturers brand their products. *It means a borderless world where there is a free exchange of money, ideas and expertise, fostering partnerships and alliances to serve the consumer best.* Globalisation relies on the quality of people. No initiatives, no innovation, no solutions are possible without outstanding people. The quality and training of people, their vision and their commitment, is the very foundation of globalisation.

Globalisation is the reversal of business from a macro to a micro point of view. What matters is the contact and collaboration between individuals and firms in various countries. Globalisation is complete decentralization of location. It will internationalise human resources and remove geographical boundaries.

The policy of globalisation emphasises that export sector should form an important ingredient of the national macro-economic aggregates. When exports form an important economic aggregate, the industrial growth to a substantial extent becomes dependent upon the export sector. When industrial production is attached to the export sector, indirectly the other sectors of the economy specially banking and services sector are also integrated with the export sector. Finally, since exports are dependent on the GDP growth of the major trading partners, the domestic economy cannot grow at a rate much different from that in the world economies.

27.3 BENEFITS OF GLOBALISATION

What are the benefits of globalisation? Some of the benefits are as follows:

i) Improved resource allocation due to the presence of a competitive environment
ii) Exposure to international economies would lead to the availability of better technology, inputs and intermediate goods
iii) Transfer of know-how and economies of scale

Thus, globalisation implies a regime of perfectly competitive markets *with no entry or exist barriers.* However, the onset of such an environment is not without fulfillment of certain preconditions on the part of the corporates – *global vision and global capability. Global vision* implies that the corporate should have the ability to analyse the dynamic competitive environment and should be able to develop superior strategies in a way, which is relevant to the new global opportunities, i.e., should have the vision of analysis and leadership.*Global capability* attributes, on the other hand, are reflected in the ability to amass and deploy productive human, technological and financial resources at the right time and at the right place.

27.4 GLOBALISATION AND INDIAN INDUSTRIES

The road to globalised markets has only fast tracks. There is no lane earmarked

for leisurely traffic. This is a primary factor to be understood. When the country opens up its markets and invites new investors and new technologies from abroad, proven suppliers can come in with their quality goods, technologies and services at competitive prices. There is thus *an anxiety that globalisation would become a one-way traffic, with imports flooding the local market, and throwing the indigenous industry and workers into misery*. However, given the fact that Indian industries have absorbed modern technologies and some quality standards over the past five decades, they have the requisite strength and resilience to face the immediate challenges of globalisation. What is needed is strategic planning to fully tap the existing strengths and meet the initial pressures. In any case, *the question today is not whether globalisation is inevitable, but how to tailor the method to fit each business when it embarks on globalization.*

One must turn the spotlight on *the information imperatives for global competitiveness.* Indian industry and business need to be on top of the corpus of information on a whole range of subjects such as product preferences, technology choices, price trends, rivals' strengths and weaknesses, and investment sources. Without such mastery, no business enterprise can successfully aspire to a razor-sharp competitive edge, which alone can assure it a recognizable market presence, let alone an unshakable market dominance.

Inevitably, companies have to spruce up all aspects of operations, in terms of technology and design, material procurement, manufacturing processes, quality levels, finance techniques and dynamics of marketing for export promotion taking fair advantage of the liberalised environment provided by the government. Effective managerial information and control systems are essential for improving in house efficiencies and for quick assessment of the external market opportunities. Timely decisions and responses from delivery dates, assured quality norms, pro-customer policies and above all, a goal orientation, are needed to succeed in global pursuits.

Productivity has to improve in all areas of management and the entire work force should wake up to the new realities through meaningful counselling and HRD techniques. A new sense of urgency to scale higher targets needs to be created in each employee and executive.Reduction in prices based on cost control and waste elimination could bring in more orders and larger profits on enhanced turnovers. This is how countries like Japan emerged world market leaders.

Competition has been the driving force for progress. A thorough reshaping of attitudes and redesign of work methods is imperative to bring in a totally new culture of activity and achievement. Each manager and supervisor has to lead by example, rather than by precepts, to prove that every new target can be achieved. Recognitions and rewards for meritorious performance in all cadres should serve as an incentive for better productivity.

Policies of trade and investment liberalisation have a crucial role to play in providing an outward orientation, which will impose external audit on the domestic cost structure. Marketing strategies will have to be evolved which should take account of the global economic restructuring that is going on in the world today. Marketing strategies suited to every target country relative to its tradition and culture should be evolved and modified from time to time for achieving results. Flexibility and effective local liaison should form the core of the strategies. It is in this context the following three points are important:

i) *Making India the premier production centre of the world*. In several sectors, particularly in *agro-based industries*, India has the skills and the investments, which make it the lowest cost producer in the world. These investments can easily obtain a share of the world market and all that is required is to develop alliances with partners overseas and support it with a national policy for each sector.

ii) Indian corporations to go into world markets and to become India's "multi-nationals abroad, with markets, and later, production centres spread across the globe. Here again, India has a natural advantage in certain sectors such as the *knowledge-led services and wide range of agricultural, industrial and fashion products*.

iii) *Attracting foreign investments* to make India their home base for their world markets. India has amongst the *world's largest trained manpower, including farmer and scientists, engineers and professionals, entrepreneurs and skilled workers*. The cost of people is much lower in India than in the developed world and provides a significant competitive advantage to India.

The introduction of *full convertibility of rupee on current account* will greatly accelerate not just foreign investments in India, but also the export-import trade.

If India succeeds in attracting foreign investment, particularly in the area of infrastructure, then it would be possible for the government to re-invest into the rural sector. This will have its own beneficial impact on the total economy, as India's prosperity is entirely dependent on the rural, farm economy. This will help to usher in a *second green revolution in the country*.

To successfully participate in the world economy, *India needs to build strategic alliances – not just between trading blocks, but between corporations; and not just between foreign partners and India but partnership within Indian industry itself*.

Check Your Progress 1

1) What do you mean by globalisation?

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2) What is the implication of globalisation for an economy?

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3) Highlight the implications of globalization for Indian industry?

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27.5 POLICY CHANGES SINCE JULY 1991

Globalisation presupposes two things — *political will at the macro level which is reflected in various policies pursued by the government and corporate will at the micro level which is established by the existence of a global vision and capability*. The government has moulded its policies. In this regard, one can take a look at the following policy changes:

i) *A two stage devaluation* of the rupee by about twenty percent in July, 1991 in an attempt to align the exchange rates with the world exchange rates and provide additional incentives to the exporters to offset some of the disincentives arising out of the import barriers.

ii) Introduction of a system of *partial convertibility* of the rupee under the *liberalised exchange rate management system (LERMS)* and then allowing full convertibility of rupee on current account.

iii) *Foreign direct investment (FDI)* has been liberalised and now the foreign investors are allowed to participate upto 51 per cent, 74 per cent, and even 100 per cent of the equity of select industrial sectors.

iv) The list of products requiring import license has been pruned which shows that *physical controls are given way to fiscal controls* (all *quantitative restrictions* are removed by April 1, 2001)

v) Import duties have been reduced.

vi) Import of *capital goods* has been allowed without any specific licence if the payment for the imported capital goods is made out of foreign exchange received for the purpose of equity participation.

vii) *Decentralization* of several items has taken place and those items, which were initially under the purview of government agencies, are now being opened to private companies.

viii) *Foreign institutional investors (FIIs)* are given permission to invest in the Indian capital market. In fact, SEBI has already recognised several FIIs for this purpose and they have started making investments also.

ix) Guidelines have been issued for the floating of *Euro* issues by the Indian companies.

x) A major step towards globalisation has been to amend the Foreign Exchange Regulation Act, 1973 (FERA), which substantially dilutes its regulatory provisions to bring it in line with the new liberalised industrial, trade and exchange rate policies. The Act has removed a large number of restrictions on companies with more than 40 per cent non-resident equity and removed FERA controls on Indian firms setting up joint ventures abroad. The amendment also incorporates into law all the changes, which have so far been made by issue of notification by the RBI or the central government. These changes pertain to facilities extended to FERA companies on the appointment of technical and management advisors, opening of branches, acquisition of immovable property by FERA companies in India, borrowing of money or acceptance of deposits by them etc. Also, in an effort to rationalise the Act, about a dozen sections of FERA, 1973 were deleted as these had lost relevance over time. (As a matter of fact FERA 1973 itself is repealed and in its place a new liberalised legislation has been enacted which is known as *"Foreign Exchange Management Act (FEMA")*.

xi) Guidelines have been specified for setting up of Indian Joint Ventures Abroad (IJVA), which would enable 90 per cent of the proposals to be covered through the automatic approval route. The main objective here is to liberalize Indian equity investment in joint ventures and wholly owned subsidiaries abroad as well as to simplify the procedures for investment abroad by the Indian parties.

xii) Automatic permission is given for foreign technology agreements upto certain ceilings covering the high priority industries.

xiii) Foreign technicians can now be hired by Indian companies without prior approval of RBI if certain conditions are met.

xiv) *The foreign investment promotion board* (FIPB) has been instituted to facilitate and promote foreign investment.

These measures establish the fact that the government is indeed serious to help the industry globalize. The industry, on its part, is becoming more and more receptive to these structural reforms. The industry has responded by opting for *industrial tie-up as a threshold to building a global strategic presence*. Thus, there is a wave of multinational corporations (Macs) entering the Indian market and Indian businessmen too are fast setting up shop on the foreign shores.

To survive the threat of global competition, *Indian companies have no choice other than to restructure their business.* The way to tackle this would be to understand the *need for change* (the way?), *the paradigm shift required* (the what?), the implementation process (the how?), and prioritisation of the problems awaiting solutions (what is next?).

27.6 GLOBALISATION OF FINANCIAL MARKETS

India has been making use of the international financial markets. Exchange rate and interest rate movements now constitute the key variables. The volatility of exchange rates has turned out to be both a proximate cause and effect of capital movements. This in turn has made them autonomous variables not directly related to movements in the real sectors of the economies concerned. Another aspect of the vulnerability results from the quick transmission of impulses generated in one leading market to others. Today, *financial markets are global in scope; where the distinction between money and other financial assets is not so clear cut and indeed there is continuum of liquidity; where the line of distinction between financial intermediation by the banking system and other non-bank intermediation is also getting blurred; and as a corollary of this where financial institutions themselves are losing their specialist character*. Their wide geographical coverage is matched by wide functional activity against the background of increasingly intense competition.This has meant better opportunities both for the players in the international financial markets and those that transact business with them. Never have the world financial markets been *so integrated and offered so wide a variety of services.*

India is affected by trends in capital movements, exchange rates and interest rates. A more liberal domestic financial sector would be better able to interact with international financial markets. India has only been reacting to events abroad, i.e., *India remains 'events takers' rather than 'events makers', but even so, there is need for providing for a measure of structured rather than ad hoc response to external events.* This is also a matter of determining the rational sequencing pattern of increasing its markets' linkages with the international markets.

A cautious and step-by-step approach in terms of a well thought out framework of such linkages is called for. While Indian financial institutions and business should gradually and in a structured way get into the operations of the international financial markets, globalisation of the Indian financial sector is indispensable if it has to become efficient, vibrant and truly competitive in the years to come. *The process of globalisation involves two distinct challenges: (i) technological upgradation through computeriation, and (ii) establishing and forging links with international financial markets*. The Indian financial sector has been a late starter in mechanizing and computerising its operations. Regrettably, introduction of new technology is rather slow. What is even worse, the installed hardware does not

seem to have been utilised to its full potential. This unfortunate state of affairs must end. *The Narasimham Committee has endorsed the view of the Rangarajan Committee on computerisation*. At the economic policy level, the issue of forging links with the international financial markets is closely intertwined *with interest rate deregulation and convertibility of the Indian rupee.*

27.7 PROBLEMS OF GLOBALISATION

An outward looking or globalisation policy carries a price, as it demands certain constraints on the formulation of national policies. These constraints are:

i) The international economic environment has qualitatively changed. When the industrialised countries are subjected to economic fluctuations, the dependent developing countries will have to bear these economic shocks.

ii) There is a relationship on the one hand between investment made for export-output and income generated via the multiplier, and on the other hand between income generated and imports via propensity to import. This problem stems from the fact that income multiplier effect in a developing economy is higher than in a developed economy due to a higher marginal propensity to consume. Consequently, demand generated is also relatively higher in the developing economies than in the developed economies. This rise in demand, under certain given conditions, will push up the domestic price level and if marginal propensity to import does not recede, it will further lead to higher imports to the extent that proportionate rise in imports may exceed proportionate rise in exports and thus the trade balance is shaken.

iii) The formation of a trade block in North America that has given rise to free trade between the US and Canada has created a new situation. With this, cartel like conditions will prevail on the demand side in these markets whereas *competition amongst the suppliers, intra-country and inter-country, will continue*. It is in these changed market conditions that India has to adjust itself. *Thus, not to speak of pushing up its share, even survival will prove a gigantic task for India*. In view of this, a better course for India will be not to rely too much on an export-led growth under the existing world scenario.

In this market oriented world there is no *godfather* who may come to India's rescue without asking for its pound for flesh.*Globalisation is perhaps irreversible. Success comes to those who learn to live dangerously. At best one can moderate the pace of globalisation. But globaliation is a conditional boon. One must put one's own house in order or at least mismanage it much less to get the boon working. India's options are limited*. One of them is to let the rupee fall freely. If the rupee depreciates, then the expectations of capping prices through imports would also be punctured.

The existing framework of global governance is weak, ad hoc and unpredictable, with international economic decision-making dispersed over numerous institutions, which are mostly dominated by the rich countries. Continued inhospitable international economic environment will frustrate the developing countries' determined efforts to end stagnation through *liberalisation, market-oriented reforms and outward-looking policies. Denial of access to markets, debt burden, inequities in global monetary, financial and trade systems, barriers to transfer of technology, dwindling flows of concessional resources, reluctance of foreign direct investment to flow to developing countries are making quantum jump from stagnation to sustained growth almost impossible.*

Domestically, there are several problems and issues, which act as hurdle towards global integration. These are : (i) *gross inequalities in income*, (ii) *poor infrastructure*, (iii) *lack of research facilities*, and (iv) *the problem of bureaucratic set up*.

According to Professor, P.R. Brahmananda (1993*) the economies are being asked to perform functions assigned to market systems without the requisite infrastructures* in storage houses, communication framework, trading establishments, organised stock exchanges, future markets, banking and financial institutions with branches, employment exchanges, commercial news-papers, advertisement media etc. Thus, *the transformation of the market has been sought to be achieved in a vacuum. Private property in land, capital and financial assets etc., has yet to be established universally. The information basis for a market economy is virtually absent. The state is simply divesting itself of its functions without compensating new institutional arrangements. Capitalism cannot be established without capitalist institutions and a legal framework.* Consequently, the transaction costs in the transitional processes have risen enormously, and great profits are being made by informal financial trading and information intermediaries. Consequently, the underlying basis for elastic supply schedules in various relative production lines has not come to exist.

The institutions such as IMF, World Bank and WTO are emerging as the watchdogs and monitors of developing countries on behalf of the developed. The loans are sources of additional demand for the products of the developed. The pressures on the moving down of exchange rates of the borrowing countries will be stronger. Further, there will be strong pressures to make the developing countries bring down the import duties and to free domestic markets.

Internationally, the point of worry is that major economies of the world are going through a major recessionary phase and are increasingly turning inwards in an effort to balance their domestic and international priorities. Thus, even they continue to preach the articles of globalisation and opening up to the world, they themselves are forming closed trading blocs, *NAFTA, Paciffic Basic Trade Bloc*, being a few such examples. Thus, there are both, opportunities and hurdles in the entire process. Whereas the domestic ones can be overcome by the necessary reforms, the trade policies and structural movements towards opening up may be slowed down by the protectionist polices of the industrial countries.

According to Uncial's Trade and Development Report (TDR) 1997, *the invisible hand (market) now operates globally and with fewer countervailing pressures.* It has sounded out a wake-up warning to countries that their faith in markets and economic openness could be overwhelmed by political events, since evidence is mounting that slow growth and rising inequalities are becoming more permanent features of the global economy.

The policy efforts of developing world should be accompanied by an accommodating global milieu. But, among the asymmetrie of globalisation is the fact that liberalization of the world economy has proceeded so far in a lop-sided way that tends to prejudice the growth prospects of developing countries by discriminating against areas in which they could achieve comparative advantage. Thus, *liberalisation of trade in goods has proceeded more slowly in those sectors where developing countries are more competitive. Major trading blocs continue to protect their agricultural sector.*

New forms of protection against exports of manufactures from the South are being sought as a remedy for labour market problems in the North. While many curbs have been lifted on the freedom of capital and skilled labour to move where it is

best rewarded, no attention has been paid to abolishing many restrictions on the freedom of movement of unskilled labour.

Ultimately global efforts to help developing countries could still come to nothing if the slowdown in economic growth in the North is not reversed. For a return to faster growth, the policy of full employment is not only a pre-requisite for resolving the twin evils of high unemployment and increasing wage inequality in the North, but is also essential for defusing the threat of a population backlash against globalisation, which might put the gains of global economic integration at risk.

Check Your Progress 2

1) Highlight the implications of globalisations for Indian financial markets.

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2) Mention three problems associated with globalisation.

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27.8 EFFORTS REQUIRED FOR GLOBALISATION

While globalisation has arrived in the world, most organisations are still not ready for it. Yet, there is little doubt that to be viable during the next century, all organisations whether domestic or international, will need to become more global in their outlook, if not in their operations. The global organisation is a consequence to several new and sophisticated forces that have come to shape the world economy over the last decade. These are: (i) aggressive and massive financial accumulation and relatively free-flowing resource turner; (ii) well-defined and efficient communication channels; (iii) information transfer and control systems; (iv) technology development and application that seek both leading edge and low-cost product creation and production and clear recognition of the potential for mass markets, mass customisation, and (v) global trends.

A joint industry-government working group set up by the Ministry of Commerce has recommended that the country should undertake corporate sector type advertising campaign in major international markets in order to improve the international image of Indian industry and goods and services. It suggested a two-step promotional strategy, beginning with a focus on image building for the country as a whole to combat its adverse image, followed by specific campaigns aimed at generating trade and investment flows.

The expansion of international trade and the rapid growth of products and services out of India will be enormously assisted *if the image of India is improved by a special, sustained and co-ordinated effort by government and industry working together. Many developing countries like India do not have strong reputations. It is therefore imperative to build credibility among a targeted group of buyers and investors.*

In this context, twelve different promotional techniques used by other countries

have been advocated by the working group. These are: (i) advertising in the general economic media, (ii) participation in trade fairs and exhibitions, (iii) advertising in sector specific media, (iv) trade missions to select countries, (v) general information seminars on trade and investment opportunities, (vi) direct mail campaigns, (vii) industry or sector-specific missions to select countries, (viii) sector-specific seminars, (ix) firm-specific research followed by sales presentations, (x) provision of trade and investment counselling services, (xi) speeding up the processing of applications, and (xii) provision of post-investment and post-trade services.

Moreover, while a host of bodies such as the Ministries of commerce, external affairs and finance, and several chambers of commerce are involved, there are no national coordinated efforts. Therefore, promotional work should be entrusted to an agency owned and funded jointly by the government and industry. However, it should function outside the purview of normal civil service rules and practices, should perhaps be a registered society, and *"should be run as a non-governmental, private sector organisation with a work culture different from government"*.

It may be emphasised that the organisation must be staffed by multi-disciplinary professionals, drawn not from the government but from the private sector.

"Essentially, a small, compact, fast moving group of people, led by a dynamic leader with task of promoting India internationally. As the international orientation of the Indian economy and Indian industry increase, it becomes essential for Indian industry to take care of details. Sustained efforts over a period, therefore, become necessary to build credibility. With this as the objective Confederation of Indian Industries (CII) has drawn up a list of *"Do's and Don't"* for Indian industry to assist companies to deal effectively in international trade.

In justifying the structural reforms that are being introduced in the Indian economy, the advocates of these reforms have brought the question of competitiveness to the centre of the discussion. Their argument runs as follows: The Indian economy needs to be integrated to the world economy. Globalisation requires that the Indian producers be competitive in the global market. It is only through these reforms that they can acquire the competitiveness and, therefore, the reforms are essential pre-requisites for successful globalisation.

Globalisation has of late become an objective in itself. This is both dangerous and ludicrous. *Globalisation should not be considered a goal in itself and that it was merely a means to the ultimate aim of improvement of the economy*. This simple objective needs reinforcement among the experts if the avoidable pitfalls of an economy in transition are to be avoided. Transition is a word that triggers both unease and heightened expectations. It is very important for us to cope with the unease if we are to satisfy the heightened expectations of nearly a billion people. The strengthening of the internal economy was a pre-requisite for a globalising economy. Given the ultimate aim of globlisation and given the pre-requisite for a globalising economy, the ultimate aim of improving the economy appears to be both the means and the end. This simplification without the use of expensive-sugar-coated words is the right approach to addressing the unease and the positive expectations.

The theoretical elegance of globalisation has its own attraction. It may help India to find some partial explanations for success and failure by systematically analysing the ability of a small set of firms to manage change. *But India needs practical and profitable applications that would be relevant to the large set of firms and individuals.* It needs consistent policies that can help to upgrade India's position in international competition in a substantial and enduring way. Towards this, *India needs to find out what it is good at so that it can better achieve the best possible*. The process of finding out what India and its firms are good at is yet to

be put into motion at the national level and all the talk about globlisation is at best wishful and premature. Globalisation requires both static efficiency and dynamic efficiency, more of the latter than the former, and India is at a stage when it is unsure of economy's static efficiency. A nation that is unsure of static efficiency is least equipped to pay for the dynamic extra options that are essential to guarantee success. The power blackouts in the states are an example of unsure, unreliable static efficiencies.

Check Your Progress 3

1) Mention five new forces that shape the world economy.

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2) Mention a few promotional techniques that need be adopted by India.

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27.9 LET US SUM UP

India ought to know what it is good at before embarking on what it needs to be good at in order to reduce the unease and sustain the expectations of a prosperous future. A prosperous future is predicted on the competitive advantage of firms in all sectors of the economy. The basis of competitive advantage in many sectors and industries, each seemingly distinct, depends on a set of critical elements common to a range of sectors. The set would obviously include transportation facilities, trained labour, energy, education and health. This set is indisputably at the heart of the economy. Its static efficiency needs to be improved. This is a prerequisite for sustaining and expanding the technical possibility set. Globalization would then be a clinch.

"Behind the cost of production of every commodity, there is a story. It may be a story of innovation, technical progress and modern labour process, or it may be one of sweated labour, primitive labour process and pollution. By putting a price sticker on all commodities, the market suppresses these stories, and thus hides more than it reveals. It is like one of those dark nights in which all horses appear gray. No country today can live behind closed doors. Third world countries therefore must globalise. But while attuning the economy to the needs of the global market, it should be kept in mind that globalization does not generate the process of development, it is the latter that leads to, and in turn is reinforced by, successful globalisation. Unless the process of development which is basically a highly localised process – successfully triggered off, globalisation may lead to the classification of the structure of underdevelopment, instead of causing its dissolution" (*Kalyan K. Sanyal, 1993*).

It is interesting to note that the Nobel Laureate Professor Amartya Sen support

removal of government control over industry and commerce and even endorses globalisation provided welfare is not ignored. He admits unhesitatingly that with the initiation of the right kind of policies, globalisation would secure more prosperity.

27.10 KEY WORDS

Backwash Effects: These operate where the economic growth in one region of an economy has adverse effects on the growth of other regions.

Common Market: An area, usually combining a number of countries, in which all can trade on equal terms.

Exchange Rate: The rate at which one currency may be exchanged for another.

Financial Capital: The liquid as opposed to physical assets of a company.

Public Utility: Essential good or service like power, gas, transport etc. A company or enterprise, which is the sole supplier of some of these essential goods or services and is, in consequence, subject to some form of government control.

Trade Blocs: Association of group of countries for safeguarding their interest vis-à-vis other non-member countries, like European Union (EU) and North America Free Trade Agreement (NAFTA), ASEAN, APEC etc., are some of the example of such trading blocs. Members of these trading blocs have eliminated all barriers to trade amongst member countries. The 15 members of EU have created a single internal market.

27.11 SOME USEFUL BOOKS

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UNIT 7 PLANNING IN INDIA

Structure

7.0 OBJECTIVES

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

- Understand the importance of planning;
- Appreciate its need;
- Explain the limitations of planning;
- Describe achievements and failures of Indian Planning; and
- Analyse the changing perspective on planning.

7.1 INTRODUCTION

The debate between planning and the market mechanism is age-old. This Unit addresses this debate. The conflict is superficial in nature. There are plenty of ways in which the two can be combined to achieve the desired goals of social and economic development. The latter part of the Unit discusses the Indian experience of planning in the post-independence period. The limitations of the planning by direction in the light of Indian experience are discussed in the last part of the Unit.

7.2 ROLE OF PLANNING IN ECONOMIC DEVELOPMENT

A free and unimpeded market system is expected to lead to maximising the national product. This maximum is also optimum from the point of view of efficiency if certain conditions are satisfied in the functioning of an economy. These are as follows:

1) *Poverty and inequalities in income distribution of all kinds are tolerated:* The market system tends to create inequalities of income and wealth. It also does not provide equal opportunities to all, especially to poorer sections in an unequal

society. In the real world, therefore, there are some constraints sought to be placed on inequalities in the distribution of income and wealth.

2) *There are no public goods.* That is there are no goods and services produced for the community as a whole and all are only for the market. However, in real world, there are always some goods and services which do not meet these criteria. These include national defence, roads, bridges, prevention of pollution etc. If left to the market these products are unlikely to be provided for.

3) *There are no externalities associated in the process of production.* In other words, there are some costs and benefits in provision of certain goods and services, which cannot be taken into account by the market system. These are goods and services like primary education, basic health facilities, drinking water and sanitation etc. These services involve large positive externalities. Similarly, costs of certain harmful drugs (involving negative externalities), though profitable, are unlikely to be accounted for by a market system. So, the market system cannot be relied upon to provide for these; and

4) *Production is not subject to increasing returns to scale.* These are those industries in which the cost of producing a good or service keeps falling as the production is expanded due to the economies of scale of production. These industries include telecommunications, power distribution, broadcasting, railways, waterways, irrigation projects etc. Therefore, if these are left to the market then they may be provided in very small quantities or may not be provided at all as losses would be incurred in producing these goods or services at the point of efficient level of operation.

Similarly, in most developing countries, increase in food production required to stave off hunger and famines may be much more than what the farmers may desire to produce at the prevailing market prices. So we see that the possibilities of such distortions, which the market system may create, indicate that the system may not always deliver the optimum result.

This raises the need for rational, deliberate, consistent and coordinated economic policy, which is what is referred to as ***Planning***. The aim of planning is to assure maximum national income through time by ***optimising*** the composition of national income with minimising the distributional inequalities.

The means employed may be either **indirect** (through **monetary, fiscal** and **commercial** policy) also sometimes referred to as indicative planning or direct (through public investment). In the indirect approach, government strives to achieve objectives of planning through changes in its policies and regulatory framework in economic activity. France is the best example of this. In India also Government has used this approach successfully in steering agricultural development in the desired direction. Direct approach, on the other hand, is based on direct state intervention in economic activity. This is done through state-owned public sector enterprises to achieve the desired goals of planning. This approach has been extensively used for the rapid development of the industrial sector in India.

Check Your Progress 1

1) What, in your view, are the three important limitations of market system?

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2) Discuss in brief the difference between direct and indirect approach to planning?

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3) Why is planning important for the developing economies?

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7.3 INDIA ON THE EVE OF INDEPENDENCE

What did India look like at the time of Independence in 1947? It was poor, obviously, but more strikingly, almost completely stagnant. The average expectation of life was a mere 33 years. India also experienced a gigantic famine in 1943, shortly before Independence; this took a toll of nearly 30 lakh people. However, this devastating famine was not directly related to the decline in the amount of food availability since it took place at a time when there was a comparatively good aggregate food crop.

Indian economy at the time of independence was overwhelmingly rural in character with nearly 85 percent of the population living in villages and deriving their livelihood from agricultural and related pursuits using traditional, low productivity techniques. The backwardness of Indian economy gets reflected in its unbalanced occupational structure with 75 percent of working population engaged in agriculture. Even with this large proportion of population engaged in agriculture, the country was not self-sufficient in food and raw materials for industry. The average availability of food was not only deficient in quantity and quality but also precarious as exhibited by recurrent famines. Illiteracy was as high as 84 percent; majority of children (60 percent) in the age group 6-11 did not attend school. Mass communicable diseases were rampant and in the absence of a good public health system, mortality rates were high (27 per thousand). Thus, the economy was faced with the problem of mass poverty, ignorance and disease, which were aggravated by the unequal distribution of resources between groups and regions.

7.4 EVOLUTION OF PLANNING IN INDIA

Policy makers in India initiated the process of planning in order to attain certain objectives within a time frame. These were particularly aiming at:

i) to speedily raise the levels of living;

ii) to catch-up with the living standards of the industrially advanced countries;

iii) to produce product-mix which could sustain growth over a longer period of time; and

iv) reducing the extent of the existing inequalities and levels of poverty in the country.

To achieve these objectives, acceleration in the rate of growth in the economy was emphasised because in a rapidly growing economy it becomes easier to tackle various problems.

The role of state in the process of planning as a tool for accelerating growth and structural break was well accepted even before independence.

7.4.1 Brief History of Planning

I) *The National Planning Committee*

Jawaharlal Nehru was the architect of planning in India. Under his Chairmanship the *National Planning Committee (NPC)* was set up towards the end of 1938. The Committee considered all aspects of planning and produced a series of studies on different subjects concerned with economic development. The Committee laid down following recommendations:

i) the state should own or control all key industries and services, mineral resources, railways, waterways, shipping and other public utilities and all those large-scale industries, which were likely to become monopolistic in character;

ii) agriculture is crucial to draw up a scheme of national planning;

iii) the planning should aim at doubling the standard of living of the people in 10 years.

II) *The Gandhian Plan*

Mahatma Gandhi was not a professional economist and did not develop a formal model of economic growth. But he advocated certain policies with regard to the development of Indian *agriculture, small-scale industries* etc. A Gandhian Plan incorporating these policies was prepared by Shriman Narayan and Acharya S.N. Agarwala in 1944. This model forms the basis of Gandhian planning, sometimes also referred to as *'the Gandhian model of development'*.

Besides the NPC eight industrialists conceived "A Plan of Economic Development" which was popularly known as *the Bombay Plan*. The famous revolutionary M.N. Roy also formulated a plan generally referred to as the *People's Plan*.

All these plans were of historical importance as there was no opportunity to implement them. Therefore, they remained on paper only. However, all these plans do indicate broad consensus about the importance of the role of state in the development process of the Indian economy.

7.4.2 Role of State as Visualised in the Planning Process

In the early 1950s it was believed that the state could play a significant role in a developing economy both in raising the domestic rate of savings and in putting it to more productive use. Indian economy was predominantly rural in character. It had land tenure system in which a substantial part of the surplus over subsistence needs of the cultivators and farm labourers got appropriated by a small class of non-cultivating land owners and intermediaries (especially under zamindari system and other feudal forms of tenure) and used for non-essential consumption. Abolition of such exploitative and socially wasteful land tenure systems could release surplus for productive investment through *land reforms* (***Land reforms*** also refers to redistribution of land from the big farmers to the landless agricultural labourers). This increases land productivity as well as improves the economic conditions of rural poor as they are mainly landless labourers. Land reforms combined with taxation of agriculture are means of exploiting this potential. Both require strong State intervention.

The state has to take the primary responsibility for providing elementary education, basic health care, safe drinking water and other facilities. These are the basic needs in any civilised society and in the Indian economy all these things were at very low level as discussed above. These also have substantial beneficial effects on the general level of productivity. Direct state intervention is necessary and justified due to the strong positive ***external economies*** (or externalities) associated with these basic services for the community as a whole (point 3 in Section 7.2).

Projects such as road networks, major irrigation works, steel plants, railways etc. call for investments on a scale far beyond the capacity of individual investors. They are in the nature of natural monopolies (also known as the public utilities) and form a category where direct involvement of the State is deemed justifiable (point 2, Section 7.2). In most cases even if the private sector is allowed to operate, the need for effective mechanism to define and enforce standards, norms of efficiency, "fair" rate of return on investment and the like is universally accepted. All of this call for state regulation, though not necessarily direct ownership and operation.

The government can also help development by creating conditions, which induce people to invest more. Low rates of savings are a reflection of low levels of income. A relatively stagnant, slow growing economy implies that profitable opportunities for investments are limited. State intervention can help expand such opportunities in several ways by creating environment conducive for faster growth. *State did this job very effectively in the Indian economy till about mid-sixties but in the later period it got into whole lot of economic activities and at the cost of ignoring its essential roles like education, health and sanitation etc.*

Public mobilisation of idle or underemployed labour for creating productive assets especially roads, irrigation canals, land improvement, schools, rural hospitals etc. increase the potential productivity of private resources and thereby creating profitable private investment opportunities. Under certain conditions, increased public expenditure can enlarge the scope for profitable investment by creating additional demand for goods and services. Both these effects are likely to be considerably strengthened if there is a coordinated programme of investments for 'balanced development' ensuring that supplies of key inputs and services grow in step with the demand for them. This aspect is particularly important in the case of activities, which are closely inter-related. With a coordinated programme, the risks of shortages or excesses of particular goods or services will substantially reduce. Reduced risks induce business to invest more.

Check Your Progress 2

1) What is the role of state in the planning process? Give two examples.

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7.4.3 Planning in Independent India

The Planning process formally started in India after the attainment of Independence when Government of India set up the Planning Commission in March, 1950. The responsibility for overall planning was vested with the Planning Commission. The Commission's mandate was quite wide:

a) to assess the country's need of material capital and human resources and to formulate plan for their more balanced and effective utilisation;

b) to review all important programmes and projects before they are approved for implementation;

c) to determine the pool of resources to be devoted to development and the allocation of this pool between various uses and users; and

d) the monitoring and evaluation of their progress.

Though formally an advisory body, it was expected that the Commission would be consulted on all major matters of development policy. Its composition was such that expert professional opinion could be brought to bear on all important matters and at the same time ensure that its counsel will carry sufficient weight in the councils of Government.

Successive Five Year Plans have sought to concretise the development strategy, programme and priorities to realise the general vision of 'growth with social justice' within the framework of a democratic polity and mixed economy. The shape and content of successive plans show a certain evolutionary process reflecting changing ideas and perceptions on the potentials and constraints on development, the relative emphasis on different objectives, and the compulsions of political and economic exigencies at various points in time.

The basic objectives and issues of economic development in India have been **growth, modernisation of the economy, self-reliance and social justice (mainly reduction in economic inequalities and removal of poverty).**

7.4.4 Plans, Planning Models and their priorities

The launching of the First Five Year Plan in April 1951 initiated a process of development aimed not merely at raising the standards of living of the people but also opening out to them new opportunities for a richer and more varied life. This was sought to be achieved by planning for growth and social justice.

The First Five Year Plan contains one of the clearest early formulations of the need for planning and of the state's role in it. Planning, it pointed out, involves "acceptance of a clearly defined set of objectives in terms of which to frame overall policies..., formulation of a strategy for promoting the realisation of the ends defined..., and working out a rational solution to problems - an attempt to coordinate means and ends". According to A. Vaidyanathan (1995), three features of this formulation are noteworthy:

1) It viewed planning as a means of utilising available resources more effectively to initiate the development process;

2) It emphasised that elimination of poverty cannot be achieved exclusively through redistribution of existing wealth or through raising output. "Purposive intervention would be required to channel economic activity within the existing social and economic order and so remodel the framework as to accommodate progressively the fundamental urges reflected in the demand for right to work, education and adequate income, protection of the aged, the sick and the disabled and ensuring that society's natural resources are used to sub serve the common good" and do not result in concentration of wealth and power in the hands of a few; and

3) It recognised that planners are not omniscient; that there are vast gaps in our knowledge of facts and that considerable amount of judgement is inevitable in making policy. The implication is that one has to keep learning from experience.

The First Five Year Plan commenced with the financial year 1950-51. It was followed by a series of Five Year Plans.

Planning process in India has had strong theoretical foundations. All the Five Year Plans have been based on different planning models. The First Plan (1951-56) was based on **Harrod-Domar growth model.** The result of this model can be set up in a simple equation:

$$I \times (1/\alpha) = I \times \sigma$$

where I represents level of investment

α = marginal savings rate

σ = marginal output-capital ratio

These concepts have been explained in detail in the previous Unit.

The Second Plan (1956-61) was based on a modified Soviet model. It was developed by **P.C.Mahalanobis**. This model was a two sector model - consumer goods and capital goods were the two sectors. This model stressed on capital goods sector. The Mahalanobis model of Second Plan stands as the centre of India' planning frame.

The *Third Plan (1961-66)* was based on the work of **Pant and Little** in **Perspective Planning Division (PPD) of Planning Commission. Manne and Rudra (1965)** prepared a consistency model for India's Fourth Five Year Plan. Unlike all the previously presented models, The Fifth Plan model incorporated a novel feature, which was ignored in earlier models. The implication of redistribution of consumption from the richer to poorer sections of the community were explicitly introduced into the planning model. The model structure behind the Sixth Plan was an extension of the model behind the Fifth Plan. The Sixth Plan attempted to integrate both the Harrod-Domar and input-output approaches of the earlier plans in a demand-supply frame. In order to impart to planning a futuristic outlook and then to make the vision a reality, the Seventh Plan (1985-90) was set within a 15-year perspective. The Plan was set out to stabilise the growth of the economy at an average annual rate of five percent. The model for Eighth Plan was also based on Seventh Plan though in this Plan the role of state for directly intervening in the economy has been considerably curtailed. The Ninth Plan follows the same path.

The following table shows the details of all the plans, their priorities and reasons for delays.

Plan	Period	Priorities	Reasons for delays
First Five Year Plan	1951-56	Agriculture	
Second Five Year Plan	1956-61	Heavy industry	
Third Five Year Plan	1961-66	Agriculture and heavy	
Annual Plans (three)	1966-69	industry Consolidation	Plan holiday because of two Wars and two successive droughts
Fourth Five Year Plan	1969-74	Removal of poverty	
Fifth Five Year Plan	1974-79	Removal of poverty and self-reliance	Did not complete its period because of change in Government in 1977.
Sixth Five Year Plan was converted to Annual Plan	1979-80	Employment	Did not complete its period because of change in Government in 1980

Plan	Period	Priorities	Reasons for delays
Sixth Five Year Plan	1980-85	Employment, food grains production and direct attack on poverty	
Seventh Five Year Plan	1985-90	Energy, employment, food grain production and raising productivity	
Annual Plans	1990-92	Infrastructure	Reformulated as the plan could not be finalised due to changes two Government
Eighth Five Year Plan	1992-97	Economic growth, employment and liberalisation	
Ninth Five Year Plan	1997-2002	Economic Growth, Infrastructure, Agriculture, rural development, environment sustainability	

Check Your Progress 3

1) What was the period of First Five Year Plan ?
   a) 1947-52
   b) 1951-56
   c) 1950-51
   d) 1948-53

2) What was the period of Eighth Five Year Plan ?
   a) 1980-85
   b) 1985-90
   c) 1992-97
   d) 1970-83

3) How many five year plans have been completed in India?
   a) 5
   b) 7
   c) 8
   d) 10

4) When was Planning Commission set up?
   a) 1938
   b) 1947
   c) 1950
   d) 1951

5) What are the broad objectives of planning in India? Describe them in brief?

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7.5 PLANNING EXPERIENCE IN INDIA

While India adopted planning under a strong interventionist State its approach to planning differed in several crucial respects from that of the socialist (former as well as present ones) economies. The latter, as is well known, had virtually abolished

private property; all means of production were nationalised; the production and exchange activities of individual enterprises were supposed to conform to targets set by the planning authority. In India, much of the means of production have been and continue to be privately owned. Despite the significant expansion of the public sector, the private sector owns more than half of the stock of capital and accounts for nearly three-fourths of the annual output. The market mechanism is active over most of the economy, even if it is imperfect and distorted.

Private property rights in India are protected by legal rights against State take-over without compensation. Except for a modest programme of land reforms and the State control over some sectors like railways, coal mines and financial institutions, the State has, as a matter of policy, avoided nationalisation of property on any large scale. Instead it has relied on a mixture of direct and indirect controls to regulate the private sector activity. Attempts to promote equitable distribution of income and removal of poverty have operated largely through fiscal policy - especially public expenditure and pricing of goods and services provided by the public sector besides some direct programmes especially designed to eliminate poverty amongst target groups.

Planning in India has brought about major structural breaks, although not to the extent desired by planners. Planning was viewed as a way of avoiding the unnecessary rigours of an industrial transition in so far as it affected the masses. During the fifties, India's development prospects were rated rather high, domestically as well as internationally. It had a stable Government, an educated elite of sizeable dimensions, a commitment to planned development, and very low defence spending. Indeed, Nehru's vision of a mixed economy moving towards a socialistic pattern of society appeared to theorists of reformed capitalism as an answer to the challenge posed by the model of growth presented by Mao's Communist China.

During the sixties the atmosphere changed drastically. Two successive droughts, wars with China and Pakistan, followed by the declaration of 'plan holidays' for three years and large scale imports of food grains brought about a great change in the international perception. Internally also there was initially great uncertainty. The savings rate dropped. Excess capacity emerged in basic sectors such as steel and capital goods. Above all there was fear that maintaining food availability per capita was going to be a great problem in years to come.

But the system did not break down. With some adjustments in policy, production revived in agriculture, especially for food grains. Within ten years of droughts, all economic indicators pointed upwards. This happened when the world was passing through the Great Recession, and many of the success cases of sixties and seventies were experiencing negative growth or only mildly positive growth. However, in the nineties with the collapse of USSR and many of the East European socialist economies the centralised planning as a tool of economic development has come under severe attack. There is a move towards decentralised and indicative planning world over. The spectacular development experience of the East Asian economies (South Korea, Hong Kong, Taiwan, Singapore, Thailand, Malaysia) also point to the strong role of indirect state intervention through manipulating market mechanism in the development process (another example of indicative planning).

The role of planning is, as a result, undergoing changes where the private sector is being encouraged much more to achieve the socially desirable outcome. France is another successful example of this kind of planning strategy.

7.6 ACHIEVEMENTS AND FAILURES OF PLANNING IN INDIA

India has completed five decades of planning. It is, therefore, important to review this entire period so as to understand the accomplishment and deficiencies of the planning experience in India in achieving various objectives of social and economic development.

7.6.1 Achievements of Planning

Reviewing the performance of five decades of planning it can be said that it is a cause of legitimate national pride that over this period a stagnant and dependent economy has been modernised and made self-reliant. Moderate rate of growth of per capita income has been maintained despite the growth of population.

The following could be included in the list of achievements of planning in India (Table 2 for details):

Table 2 : Selected Indicators of Development

	1950-51	1960-61	1970-71	1980-81	1990-91	1995-96	1999-2000
Economic Indicators							
Index of Industrial production (1993-94)	7.9	15.6	28.1	43.1	91.6	123.3	154.7
Index of Agricultural Production (1980-81 base)	46.2	68.8	85.9	102.1	148.4	160.7	178.6(P*)
Food grains (million tons)	50.8	82.0	108.4	129.6	176.4	180.4	208.9
Finished Steel (million tons)	1.0	2.4	4.6	6.8	13.5	21.4	27.2
Cement (million tons)	2.7	8.0	14.3	18.6	48.3	69.5	100.2
Coal (Million tons)	32.3	55.2	76.3	119.0	225.5	292.3	322.1
Crude Oil (million tons)	0.3	0.5	6.8	10.5	33.0	35.1	31.9
Electricity generated (TWH) (Billion kilowatts)	5.1	16.9	55.8	110.8	264.3	379.9	480.7(P*)
Wholesale Price Index 1993-94 base	6.8	7.9	14.3	36.8	73.7	121.6	145.3
Consumer Price Index (1982 base)	17	21	38	81	193	313	428
Social Indicators							
Population (Million)	361.1	439.2	548.2	683.3	846.3	915.9	
Birth Rate (per 1000)	39.9	41.7	41.2	37.2	29.5	28.3	
Death Rate (per 1000)	27.4	22.8	19.0	15.0	9.8	9.0	
Life Expectancy at birth	32.1	41.3	45.6	50.4	-	60.8	
Literacy Rate (Percent)	18.33	28.31	34.45	43.56	52.2	-	

* Provisional

Source: Ministry of Finance, Economic Survey, Various issues

I) **Indicators of economic progress:**

a) During 1950-51 to 1999-2000, our gross domestic product at factor cost (or the GDPfc) at constant prices has experienced an average growth rate of 4.1 percent

per annum. This average increased to 5.5 percent per annum in the decade of nineties;

b) Savings as a proportion of GDP have risen from 10.4 percent in 1950-51 to 25.6 percent in 1995-96.

c) As a consequence of sharp decline in death rate in this period the population grew at more than 2 percent per annum, and the net consumption grew at a modest rate of 1.4 percent per annum;

d) The process of industrialisation in India has been impressive. A major achievement has been the diversification and expansion of India's industrial capacity with the pubic sector playing a leading role. The country is self-sufficient in consumer goods and in basic commodities like steel and cement, while the capacity of other industries like fertilizers, telecommunications etc., is rapidly expanding. The growth of capital goods production has been particularly impressive, and India is in a position to sustain the growth of most of its industries, whether textiles, food processing, or chemical or sugar, power or transport through domestic production.

Index of Industrial Production (1993-94 = 100) increased from 7.9 in 1950-51 to 154.7 in 1999-2000 indicating a growth of more than 6 percent per annum. The production of finished steel increased from 1.04 million tonnes in 1950-51 to 27.2 million tonnes in 1999-00. Similarly during 1950-51 and 1999-2000 the production of cement increased from 2.7 million tonnes to 100.2 million tonnes. Likewise, the production of coal rose from 32.3 million tonnes to 322 million tonnes in the same period. There was a tremendous increase in electricity generation from 5.1 to 480.7 billion kilowatts. In 1999-00, the crude oil production increased to 31.9 million tonnes from a mere 0.26 million tonnes in 1950-51;

The per capita cereal consumption increased from 334.2 grams in 1951 to 468.5 grams in 1995, but availability of pulses declined from 61 grams to 38.1 grams per day. However, the overall availability of food grains has improved from 395 to 498 during the same period;

1) The per capita availability of edible oils and vanaspati increased from 3.2 kilograms in 1950-51 to 9.2 kilograms in 1999-00. The per capita consumption of cloth increased from 11 metres in 1951 to 30.6 metres in 1999-00. Availability of other amenities of life has also increased significantly. There has been increased use of bicycles, scooters, cars, trucks, telephones, computers, televisions, refrigerators etc., which are pointers to the progress of the society.

2) Development of economic infrastructure, energy, transport, and irrigation: Another achievement of significance is the creation of economic infrastructure, which provides the base for the programme of industrialisation. The expansion of roads, road transport, railway network and telecommunications network has made it possible to connect people and transfer goods from one part to the other part of the country and linking India with the whole world. It has considerably enlarged the market size. Irrigation and hydro-electric projects have given a big boost to agriculture and also provided energy for industries. The infrastructure has helped in modernising semi-urban and rural areas.

3) Diversification of export and import substitution: As a consequence of the policy of industrialisation and the policy of import substitution, India's dependence on foreign countries for the import of capital goods has declined. Similarly, quite a good number of consumer goods imported earlier are now being produced

indigenously. Also, the commodity composition of its exports has changed in favour of manufactures, mineral ores and engineering goods.

II **Indicators of Social Progress:**

1) **Rise in the life expectancy of the Indian people:** Whereas the life expectancy of an average Indian was 33 years in 1951 it has risen to 61 years in 1995. This is largely due to the virtual elimination of dreaded diseases like small-pox, plague, reduction of incidence of the malaria and cholera. Besides this, better health facilities have also led to a marked fall in infant mortality. Although under-nourishment accounts for poor health of a large proportion of the population, even then an increase in life expectancy is a creditable achievement.

   The other social indicators also points towards significant progress. Birth rate in India, which was 39.9 per thousand in 1950-51, declined to 28.3 in 1995-96. As against it, the death rate dropped sharply from 27.4 per thousand to 9.0 in 1995-96. Infant mortality fell from 146 to 74 per thousand in the same period.

2) **Development of a good educational system contributing to significant advances in science and technology** One of the greatest achievements of planning has been the development of the third largest pool of trained manpower with high educational qualifications. This has been crucial in the significant growth of science and technology in the country. This has considerably reduced our dependence on the foreign technology and experts. Being relatively more advanced than many other developing countries in this respect, India has started extending technical expertise to many of the Middle-East, Asian and African countries. This is a matter of legitimate pride.

7.6.2 Failures of Planning

From the credit side of the planning, now we turn to the debit side of the account and focus attention on the deficiencies of planning in India.

For over four-and-a-half decades of planning, the Government has been constantly impressing upon the people of India that development planning in India aims to build up a *socialistic pattern of society. The crucial question, therefore, is: Whether the lot of the underdog, the weak and the under-privileged has improved?* In other words, have benefits of the development percolated down to the lower layers of the Indian society? This has happened only to limited extent and evidence of that is the following:

1) *Failure to provide a basic minimum level of living to the whole population:* The basic objective of planning has been the provision of a basic needs minimum to all. But little has been achieved on this front by India.

2) *Failure to reduce inequalities of income and wealth:* There is no evidence that during the last 50 years of planned economic development, any redistribution of income in favour of the less privileged classes has taken place. Between 1950-51 and 1995-96 the per capita income has risen by 1.7 percent per annum. But even this small increase is unequally distributed. Studies indicate that the small gains of development over the years have not been equally distributed among all sections of the society. The condition of the bottom 20 percent of the population had definitely deteriorated and for another 20 percent of the population, it remained more or less stagnant. Thus, while the character of rural poverty has deepened further, there is evidence of increased concentration of income and wealth in the hands of propertied class.

3) *Failure to provide productive employment to all able-bodied persons:* With the progress of planning, the problem of unemployment as well as underemployment is also on the increase. Backlog of unemployed persons has been rising since the end of the First Plan. Development Plans in India were unable to absorb even the natural increase in labour force during each plan period, not to speak of alleviating the huge backlog of unemployed.

4) *Inadequate infrastructure availability:* Another failure of the Planning process has been the prevalence of large scale inefficiencies in construction, running and maintenance of the infrastructure projects in the public sector constraining the growth of the economy from its maximum potential. Situation has reached alarming proportions since the mid-eighties especially in case of power, railways and roads. Most of the power plants operate much below capacity (around 50%), transport infrastructure are heavily congested. The failure of the planners has been that they have been unable to foresee these bottlenecks and as a result the economy has not been able to grow at its full possible potential.

5) *Neglect of small and marginal farmers and redistribution of land:* One of the basic policy decisions to transfer ownership of land to the peasantry (i.e. the land reforms) has not been properly implemented. Though, there have been some efforts made in some states like West Bengal, Karnataka, Tamilnadu etc. It has been now admitted by the Government that progress of land reforms has been rather slow and that the state governments were not eager to implement them with a speed sufficient for quicker transition to progressive agriculture and equitable distribution of resources.

6) *The relative neglect of regionally balanced agriculture sector* has been another major failure of the planning process in India. The average land productivity of India is very low compared to most of the fast growing developing economies of East Asia and China. The average land productivity in China, for example, is more than 4 times that of India. This is due to the policy of encouraging agriculture in selected regions of the country only and leaving rest of the country-side dependent on rains for irrigation.

In conclusion, it may be pointed out that so far there has been great divergence between plan targets and their implementation. The philosophical and academic quality of the plan documents may have been fine but there has been a major crisis of implementation due to the existence of wide gap between theory and practice. It is this aspect of economic planning, which provides the Achilles' heel to our social set-up.

7.7 CHANGING PERSPECTIVE OF PLANNING

Complete planning by direction is just as much ruled out as is complete laissez-faire due to:

i) the central planner, who issues the direction, cannot hope to see and provide all the consequences of his actions. The economic system is exceedingly complex. It is because of this complexity that fulfillment of *plans by direction* is so unsatisfactory. In planning by direction the result is always a shortage of certain things, and a surplus of others. Planning by market handles all this better because, in any sphere that is affected by the decision to have more of anything, the flow of money and the adjustment of prices acts as a 'governor', turning on and off automatically.

ii) for the same reason, **planning by direction is inflexible**. The plan once made must be adhered to simply because you cannot alter any part of it without altering the whole, and altering the whole is too elaborate a job to be done frequently. The price mechanism can adjust itself from day to day, and demand and production respond; but the economy planned by direction is inflexible.

iii) the follows from these two. As the plan proceeds fulfillment is bound to be imperfect - even if the plan was perfect when it was made, conditions change. There could be a strike, an accident in a sector, which will affect the production of other sectors of the economy as well.

iv) Central planners tend to excessive standardization, not because it is good for public, but because it simplifies their job. It kills competition among the companies and discourages them to improve the quality of the product in question. So, the process of technological change also gets stifled.

v) the more one tries to overcome the difficulties of planning by direction, the more costly planning becomes in terms of resources. We cannot plan without knowledge, for which elaborate censuses, numerous forms and array of clerks are needed. The better we try to plan, the more planners are needed. The market mechanism does the same job without an array of planners who are thus released for useful work in the economy.

On account of complexity, planning by direction does not increase, but on the contrary diminishes democratic control. A plan cannot be made 'by people' or by parliament; it has to be made by officials, because it consists of thousands of details fitted together. The more we direct from the centre the less the control that is possible. When government is doing only a few things we can keep an eye on it, but when it is doing everything it cannot even keep an eye on itself.

The obvious moral of this is that the aim should be to preserve free markets wherever feasible. For the state can achieve most of its planning goals by controlling in its turn the market which controls the entrepreneur. The state can achieve plan targets in an effective manner not by direction but by manipulating the market. An appropriate policy of tax and subsidy can be used more effectively to encourage or discourage the production or consumption of any good and service.

The central issue in the discussion of planning in India has been not whether there shall be planning but what form it shall take, and in particular the state operate through the market mechanism (indicative planning) or supersession of it (centralized planning or planning by direction). Suppose for example, the government decides that, to promote industrial growth in a sustained manner, the production decisions need to be regulated. Now state could do this in various ways:

for example,

i) it could decide to set up government corporations, call public sector enterprises to directly control the production decisions;

ii) it could regulate production by making laws which ensure that anyone wanting to produce any industrial product has to take a license from the government; and

iii) it could also use the fiscal, monetary and tax-policies to encourage or discourage the production of various industry groups by adopting appropriate policies.

In the Indian context, the state used first two options more often than the last one. The system of industrial licensing and large scale investment in publicly owned

industries created a strong industrial base for the Indian economy. But around mid-sixties the inflexibilities and unnecessary bureaucratic interference started creating problems. This resulted in slow-down in the industrial growth in the 1965-1980 period. In the eighties and nineties, planners started loosening the grip of direct approach and started stressing more on the fiscal and monetary planning to achieve plan targets.

Agricultural sector, on the other hand, is an example of indicative planning. The state used pricing policy, credit policy and institutional mechanisms to promote agricultural growth and achieved the plan targets quite successfully.

Since the late seventies the planning process has been undergoing drastic changes world over due mainly to the above mentioned reasons. This is further reinforced by the collapsing centrally planned economies of former USSR and the East European economies on the one hand and the spectacular performance of the East and South East Asian economies on the other which stressed on planning by manipulating the market.

In India also, since July 1991 there is move in the same direction. The role of state in the economy is being reformulated and the private sector is being given more and more freedom to operate in almost all areas of economic activity. The **industrial licensing** has almost been completely done away with. The list of sectors reserved exclusively for the public sector has been substantially pruned. The state is withdrawing from many sectors of the economy where it had no business to be there in the first place. The only problem seems to be that it is also withdrawing from those activities like primary education, basic health etc. which require strong state intervention. This is a disturbing trend being observed of late in India.

Check Your Progress 4

1) What, in your view, have been the three major failures of the planning process in the Indian economy?

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2) What have been the three major successes, in your opinion, of the planning process in the Indian economy?

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3) Why is there a need to shift the focus of planning process in India? Do you think since the last few years the shift has been in the right direction?

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4) In India, direct and indirect approach to planning has been used for different sectors at the same time. Which sector was largely guided by direct and which by indirect approach? Discuss in brief.

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7.8 LET US SUM UP

A critical review of the Indian development plans takes us to the following conclusions:

First of all, India's macro-economic performance has been only moderately good in terms of GDP growth rates. Allowing for the fact that for the better part of the entire plan period, population has increased by more than 2 percent per annum, the growth of per capita income on an annual basis has been somewhat less than 2 per cent per annum.

Secondly, while India has had to reckon with a fair measure of inflation from time to time (1965-67, 1972-74, 1979-80 and 1991-94), the average rate of inflation has been a very modest one by international standards. There have been two major reasons for this success. One is the ability to maintain a rate of growth of food grains of around 3 percent per annum over the period as a whole. The other is the financial deepening that was experienced by the country over the last 25 years, which allowed domestic saving to go up in a monetized form. The rise in domestic saving rate from around 10% of GDP in the fifties to around 24% currently is generally judged as impressive.

Thirdly, there has been considerable capital formation in human terms. India today has a very wide base of skilled workers to draw upon, even if the level of efficiency varies a great deal across sectors.

Therefore, it would be as rash to draw a conclusion as to dismiss Indian development planning as an 'essay in failure', as to describe it on the whole as a 'great success'.

Among the major weaknesses, the following can be listed:

First, there are many areas of production where inefficiency is fairly widespread, as in generation of power, transport, steel, fertilizers let alone high-cost of consumer durables. There is no inherent reason why plant load factor (or capacity utilization level) in thermal power stations have to be around 50%. There is much greater scope for improving the efficiency of the integrated steel plants, as well as the thermal power plants.

Second, Indian planning has left a large number of people below the poverty line and poverty figures "indicate that gross poverty exists in the country, as the norm used for these purpose is based principally on calorie intake." Chakravarty, S.(1987), p 85.

Thirdly, India has not been able to employ proportionately larger population in the industry. The occupational structure has remained more or less unchanged. This has mainly been the result of higher population growth and also the industrialisation strategy followed which has been heavily biased in favour of capital-intensive industrialisation.

Lastly, the failure of the Mahalanobis strategy to the lack of comprehension on the part of the planners regarding the full set of logical implications of the accelerated growth in the context of a mixed economy. "This showed that the process of industrialization had ignored certain important issues relating to the phasing of

investment outlay. But probably more importantly, the ability to carry out effective land reforms in the early fifties when conditions had been reasonably opportune, along with maintenance of largely unchanged input base of traditional agriculture, meant that the agrarian transition was left largely incomplete." Chakravarty, S. (1987) p 8.

Hence, whereas the planning process has been able to *create social and economic infrastructure, provide an industrial base by fostering the development of heavy and basic industries, it failed employment to every able-bodied person, eliminate poverty and bring about institutional reform leading to reduction of concentration of income and wealth.* Moreover, the benefits from the economic infrastructure have largely confined to the relatively affluent and those in urban areas. These fundamental failures of the Indian planning process emphasize the need for a re-appraisal of the overall development strategy of planning. We must face the facts that the most important objective of planning has not been achieved , the most cherished goals seem to be almost as distant today as when the planning process was initiated in the country. These aims of planning - implicit in all our plans more explicitly stated in the formulation of our development strategy - are universally accepted by the Indian people; they are the removal of poverty, enough opportunities of productive employment for all, and creation of more egalitarian society.

7.9 KEY WORDS

Balanced Development: Strategy of development in which effort is made to develop all the sectors of the economy simultaneously so that the growth of the economy does not get constrained due to inadequate development of a particular sector/s.

Capital-intensive: Refers to the technique of production, which requires higher input of capital per unit of output relative to labour input.

Fiscal Year: Fiscal year refers to the year beginning April 1 to March 31 of the next year.

Fiscal Policy: Policy relating to control of government expenditure or taxation according to the requirements of the economy whereby in the periods of slowdown government expenditure is raised and economy is boosted up. Reverse is done in case of overheating case.

Increasing Returns to Scale: This is the situation when if you double all inputs for producing some product its output expands more than twice. That is cost per unit of output keeps falling as output is expanded. The Decreasing Returns to scale is just the reverse of this.

Laissez Faire: Refers to the policy of no state intervention in the economic activity in an economy.

Monetary Policy: Policy relating to control of money supply according to the needs of the economy whereby in the periods of recession extra money is injected into the system to tackle slowdown in the economy. Reverse is done in case of inflation (or overheating) case.

Public Utility: An enterprise, which is the sole supplier of some essential good or services and is, in consequence, subject to some form of government control

Public Goods: The common characteristic of public goods is non-excludability and non-rival consumption. That is it is not feasible to exclude other consumer from

UNIT 23 BALANCE OF PAYMENTS

Structure

23.0 OBJECTIVES

This unit carries the discussion of India's foreign trade started in the previous unit further. This unit goes beyond balance of trade to balance of payments, and explains its meaning. It then describes trends in India's Balance of Payments and discusses the measures that have been taken to promote exports. After you have read the unit you should be able to:

- Distinguish between balance of trade and balance of payments;
- Explain the difference between current account and capital account;
- Explain the concept of balance of payments and its importance;
- Discuss the need for export promotion;
- Evaluate the export promotion programme of the Government of India;
- Provide suitable suggestions for export promotion; and
- Evaluate various steps taken by the Government to solve the balance of payments difficulties.

23.1 INTRODUCTION

In the last Unit, we have evaluated the changing structure of India's foreign trade since independence. Trade is only one aspect of international economic transaction. A constant flow of men, material and capital takes place between nations.

This flow involves both payments and receipts of foreign exchange. A nation needs keep a systematic record of these transactions. It is only then that an economy's dependence on the rest-of-the-world and its capability to utilise external resources for its own development gets determined. This systematic record of transactions is what we call balance of payments.

23.2 CONCEPT OF BALANCE OF PAYMENTS AND ITS USES

The principal tool for the analysis of the monetary aspects of international trade is the *balance of international payments statement.* This statement is also simply known as the balance of payments (BOP*). BOP is a systematic record of all international economic transactions, visible as well as invisible of a country during a given period, usually a year*. In other words, the BOP statement is a device for recording all the economic transactions within a given period between the residents of a country and the residents of other countries.

23.2.1 Current Account and Capital Account

The analysis of the BOP can be done in terms of its two major sub-divisions viz., (i) Current Account, and (ii) Capital Account.

1) **Current Account**: The current account of the BOP can be broken in two parts. Viz., (a) balance of trade and, (b) balance of trade in services.

   a) **Balance of Trade (BOT):** The BOT deals only with exports and imports of merchandise (or visible items). The net balance in the BOT will show the monetary value of the different in exports and imports of a country. Thus, three types of net BOT can be visualised:

      i) Deficits in BOT; these will occur. When X < M ;
      ii) Surplus in BOT; these will occur. When X>M; and
      iii) Balance of BOT; these will occur. When X = M.

   b) **Balance of Trade in Services (BOS):** The BOS shows net receipts on account of trade in services, (or what are also called invisibles). We can broadly classify invisibles into five groups, viz., (i) services, such as banking, insurance, shipping civil aviation, royalty, consultancy services, postal services, etc. (ii) investment income, which includes profits and dividends on direct, portfolio and other investments as well as interest charges on bilateral and multilateral loans. (ii) travel both business and tourist, (iv) government transfers, and (v) private transfers. All of these transactions are two-way transactions; i.e. during any year these services would be provided by Indians to the rest-of-the- world, and foreigners would be providing these services to India. Indians would receive rewards for their services, which are called current receipts. Likewise, India would have to pay for the services rendered to it by the rest-of-the-world. These are known as Current payments (P). The net of current receipts and current payments constitutes balance of trade in services or BOS . During a year BOS make take any of the following three forms:

      i) Deficits in BOS; these will occur. When R< P ;
      ii) Surplus in BOS; these will occur. When R>P; and
      iii) Balance in BOS; these will occur. When R=P

Balance on current account is the sum or aggregate of BOT and BOS, i.e.,

Balance on Current Account = BOT + BOS

i.e. , balance on current account is the net of all current foreign exchange earnings of a country during a year and its liabilities in the form of foreign exchange expenditure (ex) during the year. Its foreign exchange earnings come out of the

exports of merchandise and the receipts arising out of the services rendered by it. Its foreign exchange expenditure is incurred on its imports of goods and the payments due to foreigners on account of the services rendered by them. Apparently, like BOT and BOS, current account of the balance of payments may show any of the following three results :

i) Current Account Deficits: these will occur. When imports < exports.
ii) Current Account Surplus : these will occur. When imports. > exports.
iii) Current Account Balance: these will occur. When imports. = exports.

a) **Current Account Surplus** means that a country has earned more foreign exchange during a year than what it has contracted to spend. In this situation, the country's foreign exchange reserves may increase. Alternatively, it may decide to pay off its earlier debt with the help of the surplus foreign exchange it has earned during the year. A third alternative may be that it may decide to give loans to other countries out of its own surplus earnings.

Likewise, a **Current Account Deficit** implies that a country has committed to spend a larger amount of foreign exchange than what it has earned during the year. There may be two alternatives before it now. One, it may draw upon its foreign exchange reserves, and thus settle its liabilities. Two, it may borrow abroad to settle its current liabilities; but in this case it is creating future liabilities for itself in the form of external debt.

If the current account is in balance, i.e., if a country's foreign exchange earnings during a year balance its foreign exchange expenditure, there is nothing much a country has to do in this area.

2) **Capital Account:** The other component of the BOP statement of a country is the capital account. The capital account of the BOP presents transfers of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions in the current account.

As seen earlier if a country is having a deficit on its current account BOP it need borrow from the rest of the world to square of its current excess liabilities. Likewise, if it has a surplus, it can lend to the rest-of-the world. These transactions are recorded on its capital account. All the borrowings of a country constitute the credits (cr.) in the capital account, while all lendings by it constitute its debits (dr.) in the capital account. Likewise, all repayments of old debts constitute debits, while receipts from the rest-of-the-world constitute its credits. Thus, if a country has been borrowing over a long period of time, during a particular year it would be contracting new loans (cr.) as well as paying of earlier debts (dr.) . The net of these debits and credits constitutes the capital account of the BOP.

It would be observed that the capital account transactions are designed to provide the balance of current account deficits (or surpluses). It means that if a country is having current borrowing, so that it is left with a sufficient surplus to meet its current excess liabilities, after meeting its repayments obligations of the past debt that fall due in the year. In other words, during a year,

Net capital transfers from		Current Account
	will equal	deficit **plus**
rest-of-the-world		Net repayments of past debt.

Apparently, a country will be obliged to borrow more if either its current account deficit is high or its commitments towards repayment of debt are high or both.

In any case, if a country has a deficit on its current account BOP it will need to have a surplus on its capital account BOP, the surplus on capital account will be used to finance the deficit on current account.

23.2.2 Balance of Payments

The term 'balance of payments is the' sum or aggregate of its current account and capital account. Current account and capital account will always move in the opposite directions; a deficit on current account will always meet with a matching surplus on capital account, and conversely a surplus on current account will match with a deficit on current account. And in the ultimate analysis, an economy's BOP will be in balance i.e., there will be no deficits and surpluses in aggregate BOP.

The above equality in the two sides of the BOP account is of course only an accounting equality. It would be observed that if a country continuously incurs current account deficits and finances such deficits with capital account surpluses, all that it is doing is that it is postponing its current liabilities to the future. The external debt burden will keep on increasing as new debt is further contracted.

The BOP accounts provide a link between the increase in gross external debt and the imports and spending decisions of the economy. Thus,

Increase in Gross external debt = { Current Account Deficit
- direct and long-term portfolio capital inflow
+ official reserve increases
+ other private capital outflow }

From the above relationship it would be clear that in the process of economic development a small deficit on current account is required to take advantage of the foreign savings and build up physical investments domestically.

Check Your Progress 1

1) What is balance of payments?

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2) Distinguish between visible items and invisible items of trade. Give three examples of each.

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3) Distinguish between balance of trade and balance of payments.

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4) When will a country need to have a surplus on its capital account?

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23.3 BALANCE OF PAYMENTS AND DEVELOPING ECONOMIES

It is well known in development economics that UDCs invariably start as debt or economies. In the process of development itself, these economies have to import a great deal of capital goods, consumer goods, food and raw materials and spares and components. They also have to import some new technologies and, hence, the total exchange outgo cannot be matched by export earnings. But, it is expected that in a decade or two, as the new capital goods and technologies begin to become effective and their products are directed towards exports, export goods and services become competitive in cost and quality. In that case, the volume of exports expands and, in due course, begins to overtake imports. A developing economy then moves on from being a debt or economy to a balanced one in terms of balance of payments and, finally, becomes a credit or economy, exporting more than it imports and giving credit to buyers. Thus, from being a net debt or in the beginning, it becomes a net credit or in the end and, in fact, begins to invest abroad rather than have others lending to and investing in it.

23.4 TRENDS IN INDIA'S BALANCE OF PAYMENTS

India has faced pressures on BOP from time to time either due to certain domestic compulsions or due to external factors. The whole period, covering nearly the four and a half decades, can be divided into four sub-periods depending on (i) the nature of BOP problem, (ii) the overall macro-economic environment, and (iii) the external aid situation. The four sub-periods are as follows:

1) upto 1975-76 (Period I),
2) 1976-77 to 1979-80 (Period II),
3) 1980-81 to 1989-90 (Period III), and
4) the recent phase of 1990-98 (period IV).

23.4.1 Period I (Up to 1975-76)

The entire period was very difficult for India's BOP, partly because of slow growth of exports in relation to import requirements and partly because of adverse external factors. Despite tight import controls (through quantitative restrictions) and foreign exchange regulations the current account deficit was 1.8 per cent of the GDP. Foreign exchange reserves were at low levels, generally less than necessary to cover three months imports. Almost the entire current account deficit (92 per cent) was financed by inflows of external assistance on highly concessional terms. There was hardly any commercial deficit.

23.4.2 Period II (1976-77 to 1979-80)

These few years stand out as the golden years for India's BOP. India had a small current account surplus (0.6 per cent of the GDP on an average) and foreign

exchange reserves equivalent to about seven months' imports. Export growth was good but the primary reason for the sharp improvement in BOP was the dramatic improvement in net invisibles. Net invisibles increased from a paltry Rs.193 crore in 1974-75 to Rs.2,486 crore in 1979-80.

23.4.3 Period III (1980-81 to 1989-90)

The period broadly corresponds to the period of the Sixth Plan and Seventh Plan. The Sixth Plan was launched when the economy was faced with severe BOP difficulties. In 1981, India entered into an arrangement with the International Monetary Fund for a loan for SDR 5 billion under the Extended Fund Facility. The amount was to be disbursed over a three-year period.

The BOP deficits were particularly acute during the Seventh Plan period. The current account deficit during the whole plan period was as high as 2.2 per cent of the GDP as against 1.3 per cent of the GDP during the Sixth Plan Period.

23.4.4 Period IV (1990-91 onwards)

The BOP crisis reached its climax during 1990-91; current account deficits reached a maximum of 3.26 per cent of the GDP, as would be seen from table-1 below:

Table-1: Key Indicators of India's Balance of Payments

Year	Exports (a)	Imports (b)	Trade Balance (c)	(As percent of GDP) Net invisibles (d= b-c)	Current A/c deficit (f = d+e)
Average of					
1985-90	5.1	8.3	-3.2	0.9	-2.3
1990-91	6.2	9.4	-3.2	-0.1	-3.2
1991-92	7.3	8.3	-1.1	0.7	-0.4
1992-93	7.8	9.8	-2.0	0.2	-1.8
1993-94	8.8	9.7	-0.9	0.5	-0.4
1994-95	8.8	10.5	-1.6	0.8	-0.8
1995-96	8.9	12.0	-3.1	1.5	-1.6
1996-97	8.6	12.3	-3.7	2.6	-1.2
1997-98	8.5	12.2	-3.7	2.3	-1.3
1998-99	8.2	11.4	-3.2	2.2	-1.0

India was faced with a serious BOP crisis. In view of this, a comprehensive strategy to deal with it was put in place.

Although the BOP continued to be under pressure during 1992-93, there was a distinct improvement compared to the crisis situation prevailing in the middle of 1991. Since then the BOP situation has continued to register improvement, although we have not come out of the shadows completely.

23.5 CAUSES OF BOP DEFICITS

The BOP deficits have come to stay with us for long. We will take an overall view of the causes responsible for these deficits, and would like to identify them more particularly in light of receipt happening.

1) **Balance of Trade Deficits**: The first and the foremost cause of balance of payments deficit in India has been the trade deficits that India has had to encounter right since the beginning of the growth process. The import needs of the economy went on increasing without a corresponding increase in exports, resulting in mounting trade deficits.

Even in more recent times there is sufficient evidence to indicate that the import intensity of Indian industry is rising under pressure of global competition, and with search for advanced technology this trend is certain to continue. Thus, there is apprehension that unless it is matched by high export growth there may be some risk of a substantial drain of foreign exchange reserves.

2) **Declining Surpluses on Account of Invisibles**: A marked feature of India's BOP has been that it has been earning a net surplus on account of trade in invisibles. Large earnings on account of invisibles have been due to remittances form Indians working abroad and surplus earnings on travel services. In the long run, the net position on invisibles would depend on the outcome of two opposing sets of forces-one being the surplus earnings on travel services, government transfers and private transfers and the other being the deficit on investment income. Interaction of these two sets of opposing forces would not, however, change the trend in the immediate future and invisible trade would generate surplus for some more time to come. But there exists a strong possibility that in the long run the negative forces of investment income would outweigh the positive impact of the rest of the items, leading to a deficit in invisible trade thereby creating further complications in the BOP.

3) **Mounting Burden of External Debt Servicing**: Another factor behind the increasing pressure on the BOP has been steadily mounting burden of external debt servicing. This is estimated to have increased from about $ 7.6 billion in 1989-90 to about 10.73 billion in 1998-99. Not only has the total volume of external debt been increasing rapidly, the share of short-term commercial borrowing-at market rates of interest as against concessional official development assistance (ODA)- and NRI deposits designated in foreign currencies has been increasing rapidly. With the hardening of interest rates abroad, this newly evolving pattern of external liabilities has steadily pushed up the debt service liability. Indeed, it is the increasing payment of interest on external debt – payment on current account arising from the increasing total debt liability, which has added to the need for external borrowing.

4) **Dim Prospects of Getting Concessional Aid** : During the earlier course of economic development, current account deficits could easily be founded by concessional aid both from bilateral and multilateral sources. But towards the end of eighties the various sources of concessional assistance were drying up, whereas current account deficits were mounting up. The prospects for getting concessional aid on an increasing scale appear to be bleak under the given economic circumstances, mainly because of the following four factors: (a) the generally worsening climate for official development Assistance (ODA)- most developed nations have been unwilling to increase and, in some cases, even maintain the size of their contribution, (b) the view that the Indian economy is now will equipped to tap commercial sources of foreign exchange finance; (c) the entry of new claimants

on the pool, such as China and other nations of East Europe, (d) and emergence of new independent nations, like Estonia, Lithuania, Latvia, Ukraine etc. Since commercial borrowings are quite a costly proposition there is a limit, beyond which it may not be possible for the Government to borrow. Even in case of such loans care must be taken that they should be raised for projects, which are carefully selected, speedily executed and which have direct impact on increasing our exports or reducing the magnitude of imports.

Check Your Progress 2

1) What has been the most difficult period from the point of view of balance of payments of India ?

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2) Mention four important causes of balance of payments difficulties in India?

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23.6 MEASURES ADOPTED TO SOLVE THE PROBLEM

From the point of view of the measures adopted by the government to solve the problem of BOP deficits the whole period since 1950-51 can be divided in two parts, viz. (1) 1951-91 and (2) since 1991.

1) ***Till 1991***, BOP deficits were sought to be controlled by measures like (i) promoting the growth of import substitution type of industries, (ii) putting physical restrictions on imports, (iii) extending assistance for export promotion, (iv) providing incentives for increasing foreign exchange earnings on account of invisibles. The fact that these measures could only moderately be successful is brought out clearly by the fact that the country was faced with BOP crisis of unprecedented dimensions.

2) Since 1991 India has put in practice a comprehensive strategy to overcome BOP deficits. The main elements of this strategy can be identified as follows:

a) ***Fiscal and Monetary Discipline:*** Strict fiscal and monetary discipline has been sought to be adopted to control aggregate demand. The central fiscal deficit stands reduced from 8.4 per cent of GDP in 1990-91 budget to 4.5 per cent in 1999-2000.

Monetary policy has aimed at slowing down the growth of money supply. The rate of growth of money supply has been brought down from 18.5 per cent in 1991-92 to 13.2 per cent in1995-96, and 17.8 per cent in 1998-99.

b) ***Exchange Rate Policy and Foreign Trade Policy Reforms:*** Till 1993, the exchange rate of the Indian rupee was fixed by Government. Since March 1, 1993,

a new system of exchange rate determination has been introduced. This is known as the unified exchange rate system or UERS. Under this system, all payments and receipts of foreign exchange are converted in rupees at market rate of exchange. Further, Union Budget for 1994-95 introduced full convertibility on current account that makes many trade transactions relatively free of controls. As a part of foreign trade policy reforms, imports restrictions on capital goods, raw materials and components have been virtually eliminated. Thus, excess import demand will be reflected in a higher market exchange rate and self-correcting mechanism will operate to keep trade deficit in check. Along with this considerable reductions in peak tariffs, especially tariffs on capital goods, have been affected. Cash margins and interest surcharge on import credit have been abolished. Harmonished system of customs classification has been introduced.

c) ***Structural Reforms***: Among these we may briefly mention as follows: (i) substantial deregulation of trade and industry; (ii) delicensing of many industries; (iii) promotion of competition by the opening up of many areas previously reserved for the public sector to private and foreign investment; (iv) policies put in place of attract foreign direct and port-folio investment; (v) amendment of SICA to permit public enterprises to be examined by BIFR ; (vi) financial sector reformers including deregulation of interest rates, dismantling of directed credit, reforming the banking system, improving the functioning of the capital market including the government securities market, etc.

d) ***Mobilisation of Exceptional Financing*** : Steps have been taken to mobilise exceptional finance from multilateral agencies and bilateral donors. (Exceptional financing need is defined as the requirement felt over and above the inflows of official project aid, commercial borrowings, and NRI deposits). Among other related measures are: stand-by arrangement with the IMF, structural adjustment and social safety net loans negotiated with Asian Development Bank, etc.

Results: The present strategy to overcome BOP crisis is all comprehensive and well coordinated. The results of this type of strategy have been quick to appear. The pressures of BOP have considerably eased as is brought out by the fact that the foreign exchange reserves, which touched a low of # 30,000 million presently as shown in table 2 below:

Table –2 : India's Foreign Exchange Reserves

End of March	Amount # million	Import cover (no. of months)	Current Payments cover (no. of month)
1951	1914	16.8	14.6
1961	390	2.0	1.7
1971	584	2.9	2.2
1981	5850	4.5	4.0
1991	2236	1.0	0.8
1995	20708	8.2	5.9
1996	16018	5.44	3.8
1997	21261	7.00	4.0
1998	25975	7.50	4.5
1999	29522	7.50	4.5

It would be seen that whereas in 1991 we were left with meagre reserves sufficient to cover only one month's imports and 0.8 month's current payments, now we have accumulated reserves that cover about 7 months of imports and 4 months of current payments. This order of reserves is a good cushion and provides big flexibility to policy makers.

To conclude, India has formulated a successful strategy to overcome BOP limitations on growth. But, all the same, it need be remembered that a lasting solution to the BOP problem still eludes us. Our current account deficits are still large and are once again set to rise. Large current account deficits imply that we have to take resort to external borrowings, which in turn put further pressure on BOP deficits. A lasting solution to the BOP deficits is to be found only in generation of large current account surpluses. Generation of current account surpluses, at the present stage of economic development, by and large, means that we should go in a big way to expand our exports. Rapid expansion in exports is the only way to find a permanent solution to our balance of payment problem.

23.7 EXPORT PROMOTION IN INDIA

"Export or Perish" has never been so relevant during the last four and a half decades as now.

23.7.1 Rationale of Export Promotion

Among the factors that make it almost compulsive that we increase the level of our exports, the following may be mentioned .

First, the import needs of the economy are likely to increase in future unless, as already stated, we are ready to slow down our process of growth; specifically the bill on account of direct oil imports and the investment-induced imports of foreign technology and capital put together, is likely to assume an enormous magnitude in the future. It will also be necessary to reckon with the additional deficits on account of non-oil imports.

Secondly, in the context of our past experience it may no longer sound proper to depend upon external assistance to finance essential imports. As long as such assistance is available it should be made use of, but in the process, we should not burn our own sails. Instead efforts should be on to take control of the situation whenever the external pipelines get choked up .

Thirdly, our debt-servicing burden has already assumed serious proportions and is projected to grow more serious. It may not be possible or advisable any more to contract new loans to pay off the old ones.

Fourthly, given the types of technology available, which favours large production units by bringing in economies of scale, our production structure, at least in a few important sectors, may become necessary to widen the market base by exploring new market abroad.

Fifthly, exports may also be needed to raise the earnings capacity for import of essential consumer goods like edible oil food grains (if required, at any time in future), sugar etc., whose domestic shortages have very often in the past, created serious instabilities in the economy.

Finally, the existence of a highly diversified industry, with a large entrepreneurial base experienced in assimilating technology, is providing the on-going reform process with the opportunity to generate rapid expansion in manufactured exports. Such

rapid expansion of manufactured exports would not only increase the growth rate, insulate the economy from the dangers of another round of austerity necessitated by a BOP crisis, and more importantly, provide the most direct and powerful means for eradicating poverty. As the exports basket is widened to cover a greater range of labour-intensive manufactured goods and these experience similar if not higher, rate of growth, the impact on India's poor would be as dramatic as it has been in miracle East Asian economies.

In short, the export sector is being regarded 'second only to defence' . This expresses the need for a vigorous export drive.

23.7.2 Measures for Export Promotion

Export promotion is a multi-dimensional activity. As such export promotion measures adopted by the Government have embraced a number of areas like production for export, quality control, packaging export credit and finance, export incentives and assistance, export marketing organisational set-up etc. We shall review the various measures undertaken under these different heads.

A) **Export Production**

The production for export has been given a special treatment by the Government, Industrial units in the priority sector exporting 10 per cent or more of their production are granted preferred sources of supply and facilities for further expansion of their export production.

Special treatment is also being accorded to 10 per cent export-oriented units (EOUs). The EOUs can be located anywhere in the country and are eligible for duty-free imports of capital goods, raw materials and components.

Likewise, Export Processing Zones (EPZs) on the lines of Free Trade Zones (FTZs) of Singapore and Hong-Kong have been sent up to facilitate free imports and exports. Each zone provides basic Infrastrutural facilities like developed land, standard design factory buildings, built up sheds, roads, power, water supply and drainage, in addition to whole range of fiscal incentives.

Quality Control: Intimately connected with the problem of exportable surplus is the problem of quality control. The Government has enforced quality control and pre-shipment inspection through the provision of the Export (Quality Control and Inspection)Act, 1983. Under the provisions of the Act, the Export Inspection Council has been set up to discharge all the functions relating to quality control. There is compulsory export inspection for specified products.

Packaging: Attractive packaging is as important as the quality of a product. In order to promote research in development cheap, sound and attractive packaging, the government has set up the Indian Institute of Packaging.

B) **Export Credit and Finance**

Short-term export credits in the form of pre-shipment and post-shipment finance are provided by the commercial banks, which are authorised dealers in foreign exchange. These credits have been covered by a special refinance scheme of the Reserve Bank of India and are provided at a concessional rate of interest.

Exim Bank: The government has set up the Export-import Bank wide functions to finance, promote and develop foreign trade. It came into being on January 1, 1982.

Exim Bank is the principal financial institution engaged in coordinating the working of institutions engaged in financing and promoting export and import of goods. The Bank provides financial assistance to promote Indian exports through direct financial assistance, overseas investment finance, term finance for production and export development, pre-shipment credit, buyers, credit, line of credit, relending facility, export bill rediscounting, refinance to commercial banks, finance for computer software exports, marketing and bulk import finance for computer software exports, marketing and bulk import finance to commercial banks. The diversified lending programmes of Exim Bank now cover various stages of exports i.e., from the development of exports markets to expansion of production capacity for exports, production for exports and post-shipment financing. Exim Bank's focus is on export of manufactured goods projects.

C) **Export Incentives and Assistance**

Various types of export incentives have been evolved; these have been altered and modified from time to time to meet varying conditions. Broadly, these incentives can be classified into three categories, viz., (i) fiscal incentives, (ii) financial incentives, and (iii) special incentives schemes.

i) ***Fiscal incentives***. Under fiscal incentives the important measures that have been in vogue are income tax concessions, customs drawback, refund of excise duty, exemption from sales tax, provision for export under bond, and facility for manufacture under bond.

ii) ***Financial Incentives***. These incentives refer to the provision of cash assistance for specified export promotional efforts and export facilities.

iii) ***Special Incentives Schemes***. Easy access to imported inputs through instruments like the Open General Licence (OGL), Engineering Products Export Scheme, exemption from income tax for profit from exports lowering of the tariffs, etc. are some of the measures designed as incentives to the exporters.

D) **Organisational Set-Up**

The Government has established several specialized organizations for export promotion like (i) The Central Advisory Board on Trade, (ii) The Trade Development Authority, (iii) The Federation of Indian Export Organisations, (iv) Export Promotion Councils, and (v) Commodity Boards like Rubber Board, Coffee Board, Tea Board, Tobacco Board and Spices Board. Etc.

In addition , for increasing State participation in foreign trade, a number of public sector agencies have been set up, among which the more important are: The State Trading Corporation and the Minerals and Metals Trading Corporation. The STC group now includes, besides the STC, the Cashew Corporation of India, the Handicrafts and Handlooms Export Corporation, the Project and Equipment Corporation, the State Chemicals and Pharmaceuticals corporation and the Central Cottage Industries Export Corporation.

In short, the export promotion programme of the Government covers a very broad spectrum. To an extent these measures have been successful in as much as they have made stagnant Indian exports move, although at a slow rate. A consequence of the slow growth of exports has been that India's share in world exports has been

falling gradually; presently, it stands at no more than 0.60 per cent. While , on the one hand, it reflects the poor performance of exports, on the other it also indicates, given proper opportunities, the vast potentialities for growth. Let us identify our basic limitations and suggest remedies for their removal.

23.7.3 Flaws in Export Promotion

i) A major flaw in our export promotion system is that we have been giving undue emphasis to improving price competitiveness of export products and profitability of export operations. Various fiscal, financial and other incentives have been evolved mainly for reducing cost disadvantage of export products and augmenting profitability of export marketing operations. While price plays an important role in influencing the buying decisions, other factors such as quality of the product, ability of the exporters to comply with the delivery schedule etc., also are important factors influencing foreign buyers. Therefore, export promotion measures can be effective only if they are duly co-ordinated to meet the export marketing needs in all respects i.e. distribution channels, quality of the product, etc. (ii) though many export promotion bodies and export services institutions facilitate compilation and dissemination of international marketing information, vital information directly affecting export-marketing opportunities does not get properly compiled, analysed and systematically disseminated. Also, resources constraints inhibit individual firm to effectively act on market information received. (iii) the levy of indirect taxes on export products and later the refund of the same is a wasteful process as the amount to be refunded gets unnecessarily blocked with the national exchequer thereby delaying its productive use. (iv) availing of promotional measures involves various procedural formalities, which are complicated and also time-consuming. As long as the average producer is bitten by the bug “export and perish” nothing really can be achieved.

Check Your Progress 3

1) Mention four corrective measures for balance of payments pursued till 1991.

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2) Discuss the main elements of the present strategy to solve balance of payments problem in India.

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3) Mention five structural changes introduced in Indian economic policy.

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23.8 EXPORT STRATEGY

A sound strategy of export promotion need incorporate the following features:

1) **Building up a Sound Export Production Base**

Till the recent past very little has been done to build up a stable and viable export production base and supportive infrastructural facilities to cope effectively with a growing export demand. Supply constraints and infrastructural bottlenecks have, therefore, become stumbling blocks to export efforts as an integral part of the total production programme in the export oriented sectors. Therefore, it is necessary to make a deliberate production plan and to earmark a part of production for export even if there is a pressure of domestic demand on export supplies . In this connection, D.V. Kapur Committee has suggested: (i) inducing domestic producers through more incentives to export, (ii) building in an advantage in attaining economies of scale, and (iii) further liberalisation of the licensing policies aimed at injecting intense competition.

2) **Supply of Adequate Technology**

It must be realised that a mere expansion of capacity for export production is not enough; it must be based on appropriate technology to enable us produce 6-Sigma quality products (6-Sigma indicates virtually zero defect product) so that products can stand competition in international markets. There is a growing technology gap between the world and us. Our technology may be appropriate to our needs but not for exports where updated technology is necessary. India's success in agricultural, space and nuclear research shows that it has the capacity to develop the most modern technologies if necessary resources of men and material and proper incentives are provided. While talking of technology, we should also keep in mind the need for the upgradation of packaging standards. Packaging is an integral part of the product and an important element of success of exports.

3) **Concessional Supply of Intermediate Goods**

A major hindrance to exports is the high costs of basic industrial inputs-steel, metals, plastics, glass, etc. – in the country. The only way to enable our exporters to compete fairly with their counterparts abroad is to ensure that these basic goods are available to everyone-exporters, potential exporters and non-exporters – international prices.

4) **Selectivity in Exports**

In the past we had a tendency to try and export whatever we could produce in excess of our requirements. In that context and particularly in terms of planned effort it was important that we should produce for whatever could find a market. The principle is still valid; but a glance at the range of goods that figure in world imports is sufficient to show that we cannot possibly produce all the goods for which world markets exist. Some additional criteria are, therefore, required to determine what goods India should try to produce for export. India should avoid, to the maximum extent possible, goods that are capital-intensive, energy-intensive or transport-intensive or which use domestically produced inputs that themselves are capital-intensive, energy-intensive or transport-intensive.

There are many industries where India has an advantage because of relatively

lower costs of all forms of manpower— whether it is professional or factory labour. However, while this can given an initial advantage, it should not be taken for an enduring advantage. **One**, as products become more sophisticated, labour as a cost factor becomes less and less important. **Two**, the differences in cost are narrowed down through higher levels of automation. **Three**, in processes that require large number of cheap labour, the industry is bound to shift its operation along the line of the ever-declining scale of poorer countries. So a poorer country than Indian can eventually overtake us with yet cheaper labour. Therefore, when one has established an export market on the basis of cheaper manpower, one has to be vigilant to make sure that one builds up other advantages to compensate for the inevitable loss of this temporary advantage.

5) **Expansion of Warehousing Facilities**

Warehousing facilities should be expanded in important commercial centres abroad, specially for fast-moving consumer goods. Nowadays, foreign buyers are reluctant to keep a high level of inventories and want the exporters to do so in order to enable them to buy the product in smaller quantities and at short notice. Although warehousing is an expensive operation, it pays good dividends in the long run and helps establish closer and more stable relations with the market.

6) **Supply of Trade Information**

A well directed foreign trade policy should be based on accurate trade information supported by reliable data. We have yet to conceive of a system by which this can be done. At present trade statistics are based on highly loaded information supplied by the Export Promotion Councils to obtain maximum advantage of duty drawbacks and export subsidies.

7) **Efforts to Widen and Diversity the Markets**

Indian entrepreneurs have to constantly bear in mind the fast changing trade trends and reorient their strategies, to aim at deriving higher yield by way of larger shares in the markets and better unit realisation by way of higher levels of quality and value added products. The three pronged thrust on their part would call for: (a) a relentless attempt at recovering the last ground by wresting a larger share in the world markets for sectors of traditional strength like tea, spices, jute, leather, mica and other miscellaneous agro-based products; (b) a concerted move for maintaining and enhancing the momentum gained by commodities like oil meals, basmati rice, marine products, etc; and (c) a sustained focus being kept on the sectors which have lately fared well-chemicals, engineering components, jewellery, fabrices, handicrafts, and software.

Finally, we have to realise that healthy export sector can be built up only on a strong domestic economic structure. A sound domestic economy is a must if we want a self-sustaining buoyant export sector.

In this context it may be stressed that export promotion and import substitution are neither mutually exclusive nor alternative strategies of development. They represent two sides of the same coin. The factors and policies which would be necessary to bring about an acceleration in export growth would also lead to efficient import substitution: Whether it is a better management of the public sector and an alleviation of infrastructural bottlenecks, on the other hand, or an improvement in the performance of the agricultural sector and a revival of industrial growth, on the other. In other

words, the economic determinants of the balance of payments must be related to development at a national level rather than the external sector alone, i.e., the balance of payments prospects should not be considered in isolation from the growth prospects of the economy.

Check Your Progress 4

1) Discuss the need for export promotion in India at this stage of economic development.

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2) Mention the three import measures taken by the Government for promoting exports from India.

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3) What steps we need to take to promote our exports?

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23.9 LET US SUM UP

A developing economy needs more of imports to meet the development requirements of the economy. Since the exports fail to keep pace with the import requirements the deficit is met by foreign borrowings. This has created balance of payments difficulties for India. The ultimate solution to the problem lies in promoting exports on a big scale. This needs a well-formulated strategy.

23.10 KEY WORDS

Balance of Payments: A systematic record of all international economic transactions, visible and invisible, of a country during a year.

Balance of Trade: It is an account of exports and imports of goods only of a country.

Capital Account*:* Presents transfers of money and other capital items and changes in the country's assets and liabilities resulting from the transactions in the current account

Current Account: It is an annual statement of income of a nation from the rest of the world. It states the net amount receivable or payable on account of transactions in goods and services both.

UNIT 20 TRADE POLICY

Structure

20.0 OBJECTIVES

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

- discuss the characteristics of trade policy prior to 1991 economic reforms;
- state major features of trade policy after 1991 economic reforms;
- identify the emerging foreign trade related issues in the changing nature of world trade;
- explain the role of trade policy in India's success in IT related activities;
- evaluate the export-import policy 2009-14.

20.1 INTRODUCTION

In Unit 6 and 7, we have learnt that India is moving fastly towards globalisation. Inter-dependence of the economies of the world has increased multi-fold. Trade in goods and services has gained prime importance. The share of exports of goods and services in GDP has increased from 14.0 per cent to 22.0 per cent in 2010-11 and India is now viewed as an important destination for FDI. The changes taking place in the world economy with a shift in economic strength towards

emerging markets and especially in Asia are inherently favourable for India. In such a situation, trade policy plays a crucial role. Hence, in this unit, we shall discuss the trade policy, its features in pre-economic reforms and post-economic reforms period. We shall highlight the trade related important issues like trade in services, trade and intellectual property rights, agriculture and livelihoods, and regional trade. The features of trade policy 2009-13 and its evaluation will also be discussed. To begin with let us discuss the concept of trade policy.

20.2 TRADE POLICY: CONCEPT

Trade policy is the policy followed with respect to international trade, both exports and imports. The details of the trade policy depend upon the broad trade strategy adopted in the country. The trade strategy in turn depends upon the broad strategy of development adopted by the planners. Broadly two types of development strategies have been followed in India: Inward Orientation, and Outward Orientation

Control on trade has been the important feature of India's trade policy prior to 1991. Controls on trade are divided into two sets of measures — tariff and non-tariff measures. Tariff measures relate to duties or taxes imposed on imports and exports. Non-tariff measures are those that relate to quotas or other quantitative restrictions on trade. The setting up of standards, for instance, in the import of foods is also a form of non-tariff barrier to trade. The need to secure a license to import a good is also a form of non-tariff barrier to trade.

India's trade policy can be divided into two major periods with 1991 as the dividing mark:

- Trade policy prior to 1991.
- Trade policy 1991 onwards

Prior to 1991, there were very substantial controls on international trade, particularly on imports. After the major liberalisation measures in 1991, many of the controls have been removed. India, like most countries of the world, is a member of the World Trade Organisation (WTO), hence its trade policy needs to conform to WTO rules and regulations. WTO aims to end quantitative restrictions on trade, except under certain special circumstances, and to reduce tariffs.

Under WTO rules, quantitative restrictions on imports are only to be undertaken in special circumstances, such as when exporting countries are suspected to be 'dumping' their products. Dumping is supposed to occur when products are sold below cost price. But there is a major problem in determining cost prices, and thus in identifying dumping. Cost prices may be lower in the export. Further, in a situation of over-capacity, firms may well sell below cost in order to utilise excess capacity. Consequently, it is in fact difficult to determine if dumping takes place. The usual practice is not to rely on cost estimates but on trade figures — there is a sharp and sudden increase, what is called a 'surge' in imports from a particular country, then it is suspected that dumping is involved. Overall, however, there has been a shift away from quantitative restrictions on trade.

20.3 TRADE POLICY PRIOR TO 1991

From the time of Independence till the mid-1980s, and more so 1991, India's trade policy was derived from the policy of self-reliance. The aim of planned development was taken to be the setting up of an industrial complex, capable of

producing not only final products, such as textiles, but also machinery and equipment. the aim was to set up not only consumer goods industries, but also industries producing capital goods.

Trade policy was geared towards achieving the end of developing a self-reliant production structure. There were high tariffs on imports. The intention of high tariffs was to promote domestic production, by making imported goods more expensive than those produced at home. This is what is called import substitution. There were not just import duties but various permissions required before importing something. Importing a computer, for instance, required many licenses and permissions. The central government would decide on imports, depending on its assessment of its importance for the national economy.

Import substitution had its other side — that of discouraging exports. There was no active policy of discouraging exports. But import tariffs meant that the profits from investing in import substituting production were higher from investing in production for export. Assuming that costs of production were not substantially higher in India, the profits would also be greater. In exports, on the other hand, Indian producers would have to compete with producers from other countries and there would be no excess profits for them. Thus, the policy of high import tariffs served to discourage investment in exports. As it said, high import tariffs distorted market price signals away from exports towards import substitution.

Economic policies are not just manufactured out of thin air. They are inevitably based on some theory of how the economy functions. What was the theory behind such a control on imports? The theory goes back right to the beginnings of plan development in India and was part of the formulation of the Second Five Year Plan (1961-65). The theory goes by the name of 'export pessimism'.

Export Pessimism

In the post-colonial situation of the 1950s, it was held that the export earnings of underdeveloped countries were subject to severe constraints. World manufacturing was concentrated in the industrialised or developed countries, while the under-developed countries were largely agrarian in nature. The structure of world trade reflected this division of the world economy. Under-developed countries exported raw materials and primary goods, such as coffee, tea, raw cotton or minerals. Developed countries exported manufactured products. World trade was an exchange of the manufactures of industrialised countries with the agricultural commodities and primary goods of agrarian and primary producing countries.

Manufactured goods are produced by companies, often large companies. With monopolistic market positions, these companies could determine the prices of their outputs, i.e. they were price makers. Agricultural commodities are produced by large numbers of small producers. These small producers do not have market power and cannot set prices for their products, i.e. they are price takers. On the other hand, the buyers of agricultural commodities from the developed countries are few in number. This is called a monopsony position, where there are just one or a few buyers for a product. The buyer or buyers can then be price makers for that primary commodity. The price of, say, coffee could be kept low and thus the returns to the millions of primary commodity producers would also be low.

We need to add a third dimension to the structure of world trade to complete this picture. That is the control of key mineral resources by the Multi-national

Corporations (or MNCs), sometimes also called Trans-national Corporations (TNCs) of the industrialised economies. The MNCs had operations in more than one country and they controlled much of the mineral and raw material resources of the developing countries. The classic example of this control was that of crude oil, mainly produced in West Asia, but controlled by the Anglo-American oil majors. The result of this control of crude oil was that the oil majors could keep the price of crude oil low, and give a small royalty to the governments of the supplying countries.

The role of under-developed countries in world trade was then to export agricultural commodities or minerals, non-manufactured goods of various kinds. In a competitive market, with a relatively fixed demand for agricultural commodities, an increase in production is likely to result in a fall in the price. Thus, even with an increase in production of the agricultural commodity, there may not be an increase in export earnings, since prices may fall.

Suppose there was a productivity increase by the farmers of coffee adopting more productive methods. Would the benefits of increased productivity not accrue to the producers? This would happen only if a few producers (progressive farmers) alone adopted the improved technology while the bulk of the farmers did not. Then, the progressive farmers would get the benefit of higher productivity. Their costs of production would go down. With a constant price, the higher productivity of the progressive farmers would give them higher export earnings.

But productivity improvements by farmers can easily spread beyond a group or even country. If all the producers of coffee adopt the improved practice, then the monopsony buyer could use competition among sellers to bring the price down. The premium for increased productivity would then go to the buyers from the developed countries, who may or may not pass on the benefits to consumers in their own countries. On the other hand, the MNC producers of industrialised countries did not have to pass on the benefits of increased productivity. Their monopoly positions allowed them to set prices of manufactures.

The implication of the above two propositions is that the terms of trade (i.e. ratio of prices of what a country sells to the prices of what it buys, or of primary goods' prices to manufactured goods' prices) for under-developed countries' would deteriorate. This, in brief, was the powerful analysis on what is known as the Prebish-Singer hypothesis. This was the understanding of export pessimism — that there was a strict limit to what an under-developed country could earn in the export market.

The other side of export pessimism was import rationing. Since India needed to develop its own industries, it needed scarce foreign exchange to be used mainly for importing equipment and machinery for industries. In times of food scarcity, food may also need to be imported. In this situation the limited foreign exchange earnings needed to be rationed, with the government and not players on the market deciding on what to import and what not to import on the basis of relative prices. Among all commodities that it was economically profitable to import, government would decide on the most important uses of the limited foreign exchange.

Export pessimism and import controls thus characterised Indian trade policy in the early decades after Independence. It began to change in the mid-1980s and was abandoned with the 1991 liberalisation.

20.4 TRADE POLICY 1991 ONWARDS: FEATURES AND ISSUES

The 1991 trade policy reforms were precipitated by the external debt crisis the government faced. At that time, the Indian government did not have sufficient foreign exchange to cover the external debt payments that were due. In order to avoid defaulting on its international debt obligations, the government was forced to approach the International Monetary Fund (IMF) for a loan.

The IMF usually and notoriously gives loans with conditionalities attached. These conditionalities relate to reforms that the borrowing government is required to undertake. The major reform required of the Government of India related to liberalising trade policy, basically removing import controls and letting producers and consumers decide on what to import and what to export. While changing trade policy was a condition for the IMF loan, the important question to answer is whether this change was required or beneficial for India's own development. This is a question we will return to later. But at this point, we take up the issue of why India's trade policy changed? Was there something in international experience that went against the 'export pessimism' approach to trade policy?

In the early 1960s, South Korea and Taiwan were not very different from other under-developed countries. They were largely agrarian economies and their exports were of agricultural commodities, such as rice or cassava. But in the late 1960s and 1970s, they along with Hong Kong and Singapore, which were together called the 'New Industrialising Economies' or NIEs, and later on South-east Asian countries (particularly Thailand and Malaysia) began to change the composition of their exports. From largely exporting agricultural goods they grew rapidly as exporters of light manufactures, such as garments, footwear, soft toys and plastic goods. These light manufactures were labour intensive. Since wages in these NIEs were lower than in Europe, North America or Japan, these countries were able to establish themselves as manufacturers and exporters of labour-intensive commodities.

After China's reform process in the late 1970s and early 1980s, the Chinese economy too joined in the process of establishing a strong presence in labour-intensive manufactures. In fact, China's advance in this area was helped by the fact that wages in the NIEs started going up, pushing the suppliers there to shift the labour-intensive portions of production to China.

We will return later to consider the nature of the global production and trade system that was being created. At this point, it is important to note that the NIEs, the South-east Asian economies and, most of all, China began to run up huge trade surpluses with their main trading partners, Europe and North America. This was an important and decisive refutation of the 'export pessimism' approach, which had held that there were strict limits to exports by the under-developed economies. What changed, of course, is that these economies shifted from being exporters of agricultural and other primary goods to being exporters of labour-intensive, light manufactures.

Why could India not do the same as the NIEs, SE Asia and China, a process that had made Asia the manufacturing hub of the world? In any case, the experience of these countries put an end to export pessimism and called for a new international trade policy. It called for a trade policy that paid attention to the comparative advantage of the former under-developed economies, now called developing

economies, in the manufacture of labour-intensive manufactures. The earlier, export pessimism approach was based on the traditional comparative advantage of land-abundant countries in the production of agricultural commodities. The new approach called for a trade policy based on the comparative advantage of developing countries in not just land-intensive agriculture but also labour-intensive manufacturing.

Before continuing it will be useful to look at the conditions that brought about such a momentous shift in world manufacturing trade. First, there was the development of manufacturing and management capabilities in many developing countries. In the course of attempting their own development, whether in the import-substitution method or not, the Asian countries developed substantial skills, both among workers and managers. High levels of basic education were necessary for this expansion of light manufacturing for the world market.

One major issue in India's trade policy is the 'flip-flop' nature of some of restrictions. For instance, raw cotton exports may be allowed in one season and not in the next. Or, rice exports may be allowed when there is a bumper crop and there are problems of storing grain. In the current year (2012) India has emerged as the largest exporter of rice. But there is no guarantee that it will continue to be able to export rice the next year too. Various domestic pressures work in bringing about such a 'flip-flop' type of trade policy. But it is not conducive to building a sustainable trade pattern.

Check Your Progress 1

1) What do you mean by export pessimism?

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2) State the implications of export pessimism and import control prior to 1991 period.

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3) Explain the nature of global production and trade system prevailed in NIEs in 1980s and 1990s.

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20.4.1 India and the Changing Nature of World Trade

But there is the question: how did the developing economy firms manage to get entry into developed economy markets? Did they not have to overcome local competition? The manner in which external trade in items like garments and shoes

developed was not through sale on the market, as in the case of say, rice or sugar. Rather, the developing country firms entered into contracts with buyers from the developed countries. Firms, like Gap, Nike or Adidas, sub-contracted the manufacturing work to developing country firms; therefore, the developing country firms did not have to independently search for markets. The developed country firms kept to themselves the so-called core competencies of design, branding and marketing and sub-contracted manufacturing to firms in East and South-east Asia.

This has meant a substantial change in the nature of trade. From trade in whole commodities (e.g. agricultural goods vs. manufactures) trade has now also become one in particular tasks involved in making a product. In the case of garments, for instance, the labour-intensive and relatively low-skilled tasks of making a garment or what is called Cut-Make-Trim (or CMT), possibly with inputs imported from numerous countries, is carried out in developing economy firms, while the design, branding and marketing are kept by developed economy firms. In this process intermediate products and their values enter into external trade more than once — as intermediates imported by the assembling country and then again as part of the price of the final product exported by the same country.

A very good example of trade based on such a splintering of tasks is that of diamonds and gems in India. India exports a high volume of diamonds and gems. But the export volume is mis-leading, since the raw materials or roughs, are all imported by India. These roughs are then cut and polished in India, using Indian labour for these tasks which are very labour-intensive. The full value of the cut diamonds enters into India's trade data, but all that India gets is basically the wage of cutting and polishing and the profit on that operation. There is high benefit in terms of the lakhs of workers employed in that industry. India accounts for more than 90 per cent of diamonds cut in the world. But we must note that the whole sector is not based in India. Not only raw materials are imported, but most of the diamond jewelry is designed and even set in other countries, though Indian firms are now entering into the design and manufacture of the low and middle ranges of diamond jewelry for the international market.

However, why has the opening of trade not led to India making the same advances in garments or leather products? This goes beyond trade policy, but it can be briefly noted that the historical policy of reservation for small-scale units, which continued till the early 2000s, poor infrastructure and supposedly inflexible labour regulations are all argued to have played a part in this failure of the change in trade policy to provide substantial employment in labour-intensive industries.

20.4.2 Trade in Services

Trade traditionally meant trade in goods. But the same splintering of tasks seen in manufacture has also played its role in developing international trade in services. Some services, of course, can only be provided on the spot to the consumer. Cleaning or cooking, or cutting hair can only be performed on the spot, that is, they are non-traded services. But a number of services can be provided at a distance, by foreign workers or by foreign investment.

The WTO under the General Agreement on Trade in Services (GATS) recognises three modes of trade in services. Mode 1 is by foreign companies investing in the country where the services are to be provided. Mode 2 is by off-shoring of the service to a foreign location. A good example of this are the call centers that have come up in many cities of India providing services such as answering consumer

inquiries, taking orders, etc. Mode 3 is the movement of what in legal terminology is called 'natural persons', another term for migration.

Indian firms have established a strong presence in the world trade in services. Indian firms carry out a multitude of off-shoring tasks — from simple consumer service centres, to accounting services and the various business tasks called Business Process Outsourcing (BPO). These are also called IT Enabled Services (ITES), since they depend crucially on IT and communication technology.

In fact, the major Indian IT companies such as TCS and INFOSYS pioneered the off-shoring model of global delivery of IT services. They combined on-shore staff in the developed economies with off-shore staff in India (and now also in other developing countries). They split up an IT service into components that could be carried out in these different locations and then integrated into the service to be delivered to the client. In this way, they could use the advantage of well-skilled and cheaper professionals in India to gain a cost advantage. As Indian firms began to gain market share in IT services, the major international companies, such as IBM and Accenture, countered by setting up their own units in India to nullify the Indian firms' cost advantage.

Indian firms, as mentioned above, account for a substantial share of world trade in IT and BPO services. Its contribution to Indian exports and GDP has been growing rapidly. Direct employment in these export services is of the highly qualified professionals and, at the least, of English-knowing graduates. The overall volume of employment is also quite limited, not more than 5 million altogether. But it is the success of Indian firms in the supply of IT services that has put India on the world map as a rising power.

How much did trade policy contribute to India's success in trade in IT services? Initially, in the 1980s India's trade policy actually hindered this development — since the import of the essential computers was both cumbersome and costly. But the removal of these import restrictions in 1991 made a lot of difference and enabled the export of services to really take-off.

India's trade in services is not confined to that in IT and ITES services. There is a substantial contribution through migration. Migration is of two streams. One is that of professionals to the developed countries, and the other that of skilled or relatively low-skilled workers, chiefly to West Asia. The former is often publicised but the latter is also important in terms of the remittances the workers provide. In fact, India is one of the largest beneficiaries in the world from remittances. Remittances of around $10 billion a year (check figure) have helped cover India's negative balance on trade, meaning that India's commodity exports are less than commodity imports.

Tourism is an old form of service export, where the foreign tourist spends her money in India. This has been growing very rapidly in the last decade or so, with a brief slow-down with the developed countries' financial crisis. New forms of on-site service provision are also taking place, in response to the very different prices at which similar services are delivered in India and the developed countries. With high-quality hospitals and well-qualified doctors at the top-end, India has become a new destination for what is called medical tourism.

20.4.3 Trade and Intellectual Property

In the WTO regime, trade issues have been somewhat broadened to include

matters of Intellectual Property Rights (TRIPS- or Trade Related Intellectual Property Rights). Under TRIPS all member countries are required to have a similar IP protection law. Patent rights must be allowed for products and not only processes. Before the WTO requirement, Indian IT law protected only processes and not products. As a result, Indian pharmaceutical companies could develop different processes to 'reverse engineer' products initially made in the industrialised countries. Knowing that a product, such as a statin (developed and sold by Pfizer as Lipitor) has the property of reducing cholesterol, the Indian firm reverse engineered production of statin, using a process different from that used by Pfizer. The resulting drug is sold much cheaper by Ranbaxy as Storvas.

Using these reverse engineering methods, Indian companies developed generic versions of patented drugs. These generic versions brought down the prices of drugs in the international market. A case in point was that of retroviral drugs to treat HIV-AIDS. These drugs cost more than a $1,000 for one month per patient. Obviously poor countries in Africa could not afford to treat AIDS patients with these expensive drugs. Indian companies supplied the generic versions for less than $100 per person per month. After a long battle at the WTO, there was a ruling in favour of the right to export cheap generic versions in the interest of public health.

The Indian drug companies brought a big change in the international trade in drugs through their cheaper generic versions. But with TRIPS, the IP law in India too has been changed to provide patent protection to products and not just processes. With this a profitable trade niche for Indian companies was reduced. Of course, generic drugs still come into play when drug patents expire. The Indian pharma companies have also been forced to move into the area of new drug discovery. But this is both costly and time-consuming, requiring deep financial pockets, as it is said. In attempting to move upwards from reverse engineering into new drug discovery, some of the Indian companies have had to join the international pharma majors, e.g. Ranbaxy with the Japanese Daiichi.

Before proceeding we should look into the question of why intellectual property rights have got prominence in international trade issues. As we saw in earlier section, there has been a splintering of tasks in production. Firms in the developed economies concentrate on design, branding and marketing while outsourcing manufacturing, mainly to firms in Asia. Within this division of labour in production, the surplus profits or rents are concentrated in the design and marketing segments, while the manufacturing segments get only the usual or normal profits. The reason for this distribution of income along the chain is that there is a monopoly position in the design stage, since this is intellectual property, protected by law. On the other hand, the manufacturing tasks can be carried out by any number of firms in Asia. With competition in this manufacturing segment, profits are brought down to their normal level.

This division of labour in production, designetc, by developed country firms and manufacturing by developing country firms, is the key reason why developed countries are so insistent on the protection of their intellectual property rights. With Asia and Latin America both having substantial reverse engineering capabilities, without intellectual property rights protection, the rents or surplus profits of developed country firms would soon be eroded.

Check Your Progress 2

1) How did firms from developing economy get entry into developed economy markets?

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2) List the various modes of trade in services.

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3) Name the items of India's trade in services.

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4) What do you mean by reverse engineering method?

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5) Why have intellectual property rights got prominence in international trade issues?

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20.4.4 Agriculture and Livelihoods

Another area of contention in trade policy is that towards agriculture. Agreements in this area have been stalled by the collapse of the Doha Round of WTO negotiations. The USA and European Union (EU) both provide large subsidies to their farmers. These are categorised in WTO terms under different colours — Red as trade distorting, such as an export duty or export subsidies, or Green for general support to the sector. But such general support also helps the subsidy-receiving farmers to export at lower prices. This brings down the price of agricultural

commodities and could enable the developed countries to increase their agricultural exports. The developed countries have been pressing for an agreement to reduce or, even eliminate controls on agricultural imports.

India has insisted on maintaining controls on agricultural imports, even exports for that matter. The argument is basically that agriculture is not the production of a commodity, but is also the means of livelihood of crores of small and medium farmers in the country. Particularly where new jobs in low-skill manufacturing are not growing so fast, India wants to protect its agriculture from cheap exports promoted by subsidies from the developed economies.

In a similar fashion, India has not allowed free exports of agricultural commodities. Higher quality basmati rice can be freely exported, but general rice or wheat exports are allowed only when stocks pile up in FCI godowns. This leads to a stop-go food grains trade. Neighbouring countries, Nepal and Bangladesh, both depend on their ability to import rice from India to feed their own populations. They are adversely affected by such stop-go export policies. The result is that there is a large informal trade in rice and even fertilizer (the sale of which is subsidised in India) across the large borders with Nepal and Bangladesh. PDS rice, which is also highly subsidised, also comes into this informal cross-border trade.

20.4.5 Regional Trade

Regional trade is very limited in South Asia — just around 3 per cent for a long time and now just below 5 per cent of total international trade of the South Asian countries. This should be contrasted with regional trade of 30 per cent for East Asia and SE Asia. On all sides of the South Asian borders, there have been misgivings about increasing regional trade. India being largest economy in the region, owes clear responsibility in promoting regional trade.

Starting with the Gujral Doctrine, the Government of India declared its intention to grant unilateral concessions to neighbours in order to stimulate regional trade. Recently the Government announced the removal of all restrictions on imports of garments from Bangladesh. It has also entered into an Investment Protection Treaty with Nepal. All this will help stimulate regional trade.

But attempts to reduce protectionist barriers face concerted obstacle, from the still relatively inward-looking economic policies of South Asian countries. There are politically strong lobbies within each country that feed on the general policy of looking for subsidies as a way of dealing with problems of loss of competitiveness, rather than looking at ways to increase productivity in order to remain competitive. When, for instance, the India- Sri Lanka Free Trade Agreement (ISLFTA) resulted in spice imports from Sri Lanka displacing local spice production, there was an immediate demand by Kerala spice producers for protection against Sri Lankan imports. This is not unusual in India. These lobbies remain opposed to trade-opening measures if their markets are likely to be affected. Rather than subsidies, the way forward is to look for measures that would increase competitiveness.

India-Pakistan trade is largely carried out through Dubai, which obviously increases the cost of trade. Despite this cost increase, Indo-Pak trade via Dubai is about $2 billion per year. Were trade to be carried out more directly, there would be a clear increase in trade between the two countries. India, with it current emphasis on infrastructure, has imported substantial quantities of cement from Pakistan. This is facilitated by the use of the land route, rather than the third party Dubai route.

Numerous chemicals are imported by Pakistan. But besides these imports, there is a long negative list of items that are not to be imported. This includes pharmaceuticals, where Indian firms with their generic production are much cheaper than current Pakistani production. But the strong lobbies that wish to protect domestic production result in the long negative list.

At the same time, it should be noted that there is also an increase in strength of lobbies that support trade opening. In the recent situation with regard to commodity exports between India and Pakistan, some trading lobbies have clearly acted against the political interests. While Pakistani traders obviously wanted to take advantage of India's onion shortage, increased export was stifled by Pakistan political interests that wanted to restrict these exports. Similarly, when Indian cotton traders wanted to increase exports of raw cotton to Pakistan (where the cotton crop was affected by the floods), this was opposed by Indian textile owners, who wanted to profit from the bumper Indian cotton harvest. In the absence of exports, the bumper harvest would lead to a fall in the price of raw cotton, benefitting the textile mill owners.

What should be the basis of regional trade policy? This is a matter of much debate. In the development ladder, there is a difference between 'developing economies', 'less developed countries' (LDCs) and 'emerging economies'. Emerging economies, such as India and China, have both technology and scale advantages over both LDC and other developing economies.

Most Regional Free Trade Agreements (RFTAs) are based on the principle of equal access to each other's markets. Equal access, however, is likely to lead very unequal trade outcomes, when countries are at different levels of development. Countries with different economic capabilities, due to differential access to capital, technology and scale, would not be able to compete on equal terms. Consequently, a RFTA with a development agenda needs to incorporate the system of non-reciprocal access. Non-reciprocal access means that the more developed economies grant unilateral concessions to the less developed economies. Thus, India has opened up its garments sector to Bangladesh, without demanding that Bangladesh do the same in return. The reason for such non-reciprocal access is that the less developed countries need access to the larger markets of the more developed countries.

Non-reciprocal access is now generally accepted with regard to LDCs. In the pre-WTO period non-reciprocal access was part of the trade agreements in the form of what was called Special and Differential Treatment (SDT). Non-reciprocal access, however, has come in a number of multilateral trade agreements, such as the USA's AGOA (African Growth and Opportunity Act) and the EU's 'Anything but Arms' for Africa.

This principle can be extended to a South Asian Free Trade Agreement or SAFTA. This would recognise that India, as an emerging economy, has an advantage over the smaller and or poorer economies. Such non-reciprocal access would enable SAFTA to utilise the size and strength of the Indian economy to act as an engine of growth for the region.

A system of non-reciprocal access in SAFTA would help overcome the fears of the small South Asian countries, which fear domination by India. At the same time, it will force Indian firms to move up the value chain. South Asian regional trade faces many political obstacles. But an imaginative trade policy by India is beginning to make an impact on the region.

20.4.6 TRADE – LABOUR AND ENVIRONMENTAL STANDARDS

There has been much discussion of the connections between trade and labour and environmental standards. International trade is clearly connected with a difference in labour standards, certainly at the level of wages. Countries with a large labour force tend to have lower wages levels and, thus, to specialise in the production and export of labour-intensive products and tasks. Sometimes the labour involved could be of morally repugnant types, such as child labour or forced/bonded labour. Should commodities produced by such forms of forced labour be allowed in international trade?

This was a subject of much international discussion in the 2000s. The developing countries, including India, insisted that trade policy was not the appropriate instrument or the WTO the appropriate forum, to discuss issues of labour standards, which should be taken up by the International Labour Organisation (ILO). They insisted that there should not a linking up of trade access and labour standards.

At the level of trade policy it has been internationally agreed that trade action, such as banning imports made with child labour or forced labour, should not be used as an instrument for improving labour standards. But, it should be noted, that many private codes of buyers, such as Nike, Marks and Spencer, or any other big buyer — the labour codes that they expect their suppliers to adhere to include matters such as the non-employment of child labour. Even though Indian law permits non-hazardous work after the age of 14, these global buyers usually insist on 18 years as the cut-off age.

Thus, even if at the level of inter-governmental trade policy labour standards do not come into discussion, in actual trade, in actual contracted selling of garments and other such products, the issue of child labour very much comes into the picture. Thus, there in fact has been some improvement in non-employment of child labour in many areas of garment production. But, even in this, it should be noted that such non-employment is really only enforced and monitored at the factory level. In tasks, such as hand embroidery, which are often out-sourced to the household level, it is difficult to monitor the employment of child labour — unless a switch is made to, say, community-level centers for hand embroidery or to factory-level work.

There are many other issues of forced labour or of labour rights, such as the right to form trade unions, in which there are violations. But these issues have not got as much attention as child labour. Recently, however, not in India but in China, there has been a lot of publicity over poor work and wage conditions in Foxconn, a major contract manufacturer for the American Apple company.

If trade depends on differences in labour standards between countries, is there a similar role for differences in environmental standards? Environmental standards are generally weaker and poorly enforced in developing as compared to developed countries. Will there then be a tendency for polluting industries to be exported to the ‘pollution havens’ of developing countries? Does poor environmental standards became a factor, in addition to low wages, in the location of polluting industries in developing countries? Poor environmental standards would certainly contribute to an export of polluting tasks to developing countries. There is a cost involved in meeting environmental standards. In order to avoid such costs, there would be a tendency to export polluting industries to developing countries, where such monetary costs may not be incurred by the firm concerned.

But here two points should be noted. Not all that is exported as waste actually has no value. An article that is no longer usable, is not therefore 'waste'; it would have many useful components; it could even be repaired and resold on the seconds market. Second is that the handling of such waste often provides a large number of jobs.

Take the example of ship-breaking. At the end of its life as a ship, the ship is taken to Alang Port in India. There it is broken up. Iron and steel goes to steel rerolling mills. Marine engines are often repaired and used as generators. In fact, most of what makes a ship is separated and sold for re-use. Thus the notion of waste, as something that has no value is a misnomer here. What is waste goes back as inputs into production of different types. Further, most of the labour involved in such breaking up and separating is labour-intensive, it is inevitable that such tasks will be located in developing countries where labour is relatively cheap.

Consequently, the treatment of waste creates many jobs and yields many useful inputs into new production. What, however, is needed is to see that hazardous and dangerous materials are not handled inappropriately. For instance, ships often contain asbestos and mercury, the handling of both of which requires care and appropriate technology. The international Basle Convention on the handling of waste requires that such hazardous material be properly handled and removed before the ship, for instance, is sent for breaking up to a developing country. This, of course, is often violated. But it can be checked, as the Indian Supreme Court did when it insisted that the French aircraft carrier, *Clemenceau*, could not be brought to India until all hazardous materials were removed.

On the other hand, as in the matter of eliminating child labour, it should be noted that participation in international trade can lead to an improvement in environmental standards. For instance, the Indian processes of tanning leather and dyeing cloth, both of which largely take place in the informal sector, often use very dangerous chemicals. The import of leather products or garments made with such dangerous chemicals is often banned by the developed countries. As a result of this, some of these supply chains have been cleaned up, as for example the leather product supply chain around Chennai. But such improved labour and environmental standards often remain confined to just the exporting chains; similar chains producing for the domestic market remain without such improvements.

20.5 EXPORT- IMPORT POLICY 2009-14

The long-term exim policy for the period 2009-14 was announced on August 6, 2009.This policy has been formulated in the backdrop of an unprecedented contraction in exports, tax refunds for exporters, lower transaction costs, promises of better infrastructure and a broader strategy to ship more Indian goods and services to new markets in Latin America, Oceania and Africa instead of traditional, but recession-stricken markets in Europe and North America are some of the highlights of this policy.

20.5.1 Objectives

The short-term objective of the policy is to arrest and reverse the declining trend of exports and to provide additional support especially to those sectors which have been badly hit by recession in the developed world.The policy aims to achieve an annual export growth of 15 per cent, with an annual export target of $200 according to the situation.

The government hopes the country would return to a high export growth path of around 25 per cent per annum, and double exports of goods and services, both by 2014. In the long-run the policy aims to double India's share in global trade by 2020, which stood at 1.64 per cent in 2008.Other long-term objectives of the policy include to:

- accelerate the country's transition to a globally-oriented vibrant economy to derive maximum benefits from expanding global market opportunities.
- stimulate sustained economic growth by providing access to essential raw materials, intermediates, components, consumables and goods required for augmenting production.
- enhance the technological strength and efficiency of Indian agriculture, industry and services, thereby improving their competitiveness, and encouragement of internationally accepted standards of quality.
- provide consumers with good quality product at reasonable prices.

20.5.2 Major Features

- **Support for Market and Product Diversification**

i) Incentive schemes under Chapter 3 have been expanded by a way of addition of new products and markets. Twenty six new markets have been added under Focus Market Scheme. These include 16 new markets in Latin America and 10 in Asia-Oceania.

ii) The incentive available under Focus Market Scheme (FMS) has been raised from 2.5 per cent to 3 per cent. The incentive available under Focus Product Scheme (FPS)has been raised from 1.25 per cent to 2 per cent. Large number of products included for benefits under FPS.

iii) Market Linked Focus Product Scheme (MLFPS) has been expanded to products in pharmaceuticals, synthetic fabrics, value added rubber and plastic, textile made-up knitted and crocheted fabrics, glass products, iron and steel products, aluminium.

- **Technological Upgradation, EPCG Relaxation, DEPB**

i) EPCG Scheme at Zero Duty for engineering and electronic products, basic chemicals and pharmaceuticals, apparels and textiles, plastics, handicrafts, and leather. Not available for current beneficiaries of other schemes like TUFS, or Status Holder scheme.

ii) To increase the life of existing plant and machinery, export obligation on import of spares, moulds under the EPCG Scheme has been reduced to 50 per cent of the normal specific export obligation.

iii) Taking into account the decline in exports, the facility of Re-fixation of Annual Average Export Obligation for a particular financial year in which there is decline in exports from the country has been extended for the 5-year policy period 2009-14.

iv) To accelerate exports, additional Duty Credit scrips shall be given to status holders @1 per cent Scrips of the FOB value of past exports. The Duty Credit scrips can be used for procurement of capital goods. This facility will be available till March 31, 2011.

v) The policy permits transfer of the Duty Credit scrips being issues to status holders. The transfer can be made only to status holders and scrips can be used only to procure cold chain equipment.

- **Stability/Continuity of the Foreign Trade Policy**

i) To impart stability to the policy regime, the Duty Entitlement Passbook (DEPB) Scheme is being extended by a year till December 31, 2010. The interest subvention of 2 per cent for preshipment credit for 7 sectors extended till March 31, 2010 in Budget 2009.

ii) DEPB rate shall also include factoring of custom duty component on fuel where fuel is allowed as a consumable in Standard Input-Output Norms.

iii) Income Tax exemption to 100 per cent EOUs and to STPI units IT Act has been extended for the financial year 2010-11 in Budget 2009-10.

iv) The adjustment assistance scheme initiated in December, 2008 to provide enhanced ECGC cover at 95 per cent to the adversely affected sectors is continued till March 2010.

- **Sops for Export-oriented Units**

i) EOUS have been allowed to sell products manufactured by them in DTA up to a limit of 90 per cent instead of existing 75 per cent, without changing the criteria of 'similar goods', within the overall entitlement of 50 per cent for DTA sale.

ii) To provide clarity to the customs field formations, the revenue department will issue a clarification to enable procurement of spares beyond 5 per cent by granite EOUs. EOUs will be allowed to procure finished goods for consolidation, subject to certain safeguards.

iii) Board of Approvals (BOA) will consider extension of block period by one year for calculation of Net Foreign Exchange earning of EOUs. EOUs will be allowed credit facility for the component of SAD and Education Cess on DTA sale.

- **Thrust for Value-Added Manufacturing**

i) To encourage Value Added manufactured export, a minimum 15 per cent value addition on imported inputs under Advance Authorisation Scheme has been prescribed. Project Exports and a large number of manufactured goods brought under FPS and MLFPS.

- **Flexibility Provided to Exporters**

i) Payment of customs duty for exports obligation shortfall under Advance Authorisation/DFIA/EPCG. Authorisation has been allowed by way of debit of Duty Credit scrips. Earlier, the payment was allowed in cash only.

ii) Import of restricted items, as replenishment, will be allowed against transferred DFIAs. Time limit of 60 days for re-import of exported gems and jewellery items for participation in exhibitions has been extended to 90 days in case of USA.

- **Simplification of Procedures, Reduction in Transaction Costs**

i) To facilitate duty-free import of samples by exporters, number of samples/

pieces has been increased from the existing 15 to 50. Customs clearance of such samples shall be based on declarations given by the importers for value and quantity of samples.

ii) To allow exemption for up to two stages from payment of excise duty in lieu of refund, in case of supply to an advance authorisation holder (against invalidation letter) by the domestic intermediate manufacturer.

iii) No fee shall now be charged for grant of incentives under Chapter 3. For all other 18 Authorisations, maximum fee is being reduced to Rs. 100,000 from Rs. 1,50,000 and Rs. 50,000 from the existing Rs. 75,000 (for EDI applications).

20.5.3 Evaluation

Positive Features

- The Foreign Trade Policy identifies the three major pillars that would support India in achieving the target of doubling its export of goods and services by March 2014. The three pillars are: improvement in export-related infrastructure, lowering of transaction cost and providing full relief on all indirect taxed and levies.
- The overall approach of the policy pronouncement recognises the vulnerability of certain sectors, which are employment-oriented and sensitive. Thus, a number of initiatives have been announced that should enable enhanced market access through revamped schemes such as the focus market, focus product and market-linked focus product schemes.
- It is noteworthy that the incentive available under the focus market scheme has been raised by half a per cent to 3 per cent and the incentives in focus product scheme from 1.25 per cent to 2 per cent. Along with the marginal increase in the rate of incentive, the coverage has also been extended fairly significantly. The 26 new markets that have been added to the focus market scheme include 16 in Latin America and 10 in Asia-Oceania, including comparatively larger markets such as South Africa, Brazil and Mexico and this would enable our exporters to get the benefits under the schemes which were hitherto denied to them.
- The new policy initiatives relating to import of capital goods are indeed timely. The EPCG scheme has really been benefiting the upgrade and modernisation of India's export manufacturing sector and the new incentive of giving access at zero duty capital goods import facility should go a long way in speeding up the process of technology upgrade.
- The policy would give special thrust to the employment-oriented sectors that had witnessed job losses in the wake of recession, especially in the fields of textiles, leather and handicrafts.
- The steps announced with regard to electronic message exchange between Customs and the Directorate General of Foreign Trade (DGFT), stoppage of double verification of shipping Bills by Customs for DGFT Schemes and exhortation to Export Promotion Councils to issue RCMC Certificates through EDI are welcome.
- While enhanced benefits for market development and promotion schemes would enable the exporting community to explore new export destinations, incentives for technological upgradation such as zero duty EPCG benefit and

1 per cent additional duty credit for status holders for several important sectors would greatly help in stepping up India's competitiveness.

Negative Features

- One area of concern the FTP has not highlighted is the fall in imports in tandem with exports, continuing a decline that started in early 2009. Lower non-oil imports indicate a slowdown in the domestic investment. Lower imports have narrowed the merchandise trade deficit in the BoP, an outcome that would be favourable had it been achieved through robust export performance.
- Another worry relates to growing protectionism abroad, especially in the developed countries. India which has recently concluded trade agreements with South Korea and ASEAN hopes to play a major role in restarting Doha development round of talks. Some of India's export promotion schemes such as DEPB scheme are not compatible with the WTO rules and need to be taken up for review.
- While inclusion of 17 technical products in the focus product scheme was a welcome step, limiting benefits such as one per cent additional duty scrips for status holders and zero duty for imports under the EPCG scheme to units that were not taking benefit from the Technology Upgradation Fund Scheme was disappointing, as most textile units were covered under the scheme and they would be denind the benefits.
- Addition of more countries under the market-linked focus product scheme would be of no use as the list of products eligible for incentives under the scheme covered only garments, made-ups, knitted fabrics and synthetic textile fabrics. Countries like Cambodia and Vietnam, which have been covered by this facility, are among major exporters of garments. On the other hand, they import substantial quantities of yarn and woven fabrics. However, these products have not been extended the benefits, except synthetic textile fabrics.
- It is true that globally all major indicators such as industrial production, unemployment, per capita investment and consumption, have taken a big hit. WTO estimates that world trade will decline by 9 per cent during 2009. If this is so, the question to be addressed is what can a domestic trade policy do to counter global trends. Solutions have to found so that India's exports recover in the face of such a massive demand slump, particularly in the developed world. The FTP is silent on this account. There is no reason why the FTP should not attempt measures to shore up India's exports.
- The policy has incentivised import of capital goods with Actual User Condition, by providing additional duty credit scrips at the rate of 1 per cent of FOB value of export to status holders in specified sectors. To what extent would this be beneficial is doubtful, as most of the status holders are merchant exporters and hence they would find it difficult to meet the requirement of the Actual User Condition.
- The new FTP seems to be founded on the belief that time-tested export promotion schemes have contributed to export growth and, therefore, must be retained. So, it fails to make a significant break from the past, it creates more reasons for the exporter to go the licensing offices and do more paperwork. It puts more power in the hands of the officers in the licensing offices and thus creates more avenues for corruption.

- The policy does not compensate for a comprehensive and competitiveness enhancement strategy in the form of a stimulus package as Indian goods are over 20 per cent costlier countries like China, Bangladesh, Vietnam and Cambodia. The higher cost is due to higher credit rates, wages for labour and transaction costs.
- While the pillars of foreign trade growth-infrastructure, reimbursement of duties and reduction in transaction costs-have been addressed, the policy has restricted itself the near-term objective of sustaining the current level of exports. The policy has done little from the stability points of view as fiscal sops have been offered only till 2011. Besides, something should be done for exporters obtaining cheaper bank finance, something that has been happening in countries which are our competitors.
- Mere fiscal incentive will not spur export growth. Today, the core problem is that there is no demand for our export products because of global recession. So what we need to do is to make our exports more competitive so that we score over our competitors. For this, our logistics costs have to come down from current 13 per cent to 8 per cent, which is the cost internationally. For this all, related ministries have to come together and improve facilitation of exports as well as imports.

Check Your Progress 3

1) State the meaning of the term 'stop-go' food grains trade.

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2) What is the basis for having Regional Free Trade Agreement?

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3) Identify three major pillars of Exim Import policy 2009-13 aiming to the export of goods and services.

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4) Describe three disadvantages of trade policy 2009-13.

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20.6 LET US SUM UP

Trade policy refers to all the policies related to both exports and imports. After independence, Indian trade policy was characterised by export pessimism and import controls. This situation began to change in 1980's and control regime was abandoned after 1991 economic reforms. In the changed situation of world trade, firms in the developing economies have managed to get entry into developed economy markets. India account a substantial share of world trade in IT and BPO services – its contribution to Indian exports and GDP has been growing rapidly. Due to division of labour in production, design by the developed countries etc. intellectual property rights have got prominence in international trade issues. Agricultural products due to subsidy to its farmers by developed countries is another area of controversy in trade policy. Regional trade is confined to only 3 per cent in South Asia and there have been misgivings about increasing regional trade. India being largest country in the region owes prime responsibility in promoting regional trade. The long term export-import policy 2009-14 aims to double India's share in global trade by 2020 and accelerate the country's contribution to global vibrant economy to derive maximum benefits from expanding global market opportunities.

20.7 EXERCISES

1) 'India's trade policy prior to 1991 was derived from the policy of self-reliance' – In the light of this statement critically evaluate India's trade policy.

2) Explain the important issues which are crucial and hence need to be addressed in India's trade policy.

3) Evaluate the Export-Import Policy 2009-14.

20.8 KEY WORDS

WTO – World Trade Organisation : Set up as the successor to the General Agreement on Trade and Tariffs (GATT). Its headquarters is in Geneva, Switzerland. The WTO is a membership based organisation. A member, on being accepted, agrees to all the instruments of the organisation. Unlike GATT, the WTO has a dispute resolution mechanism. Any member is free to take up a case against any other member. This allows for formal equality, but it is often difficult, because of the cost of engaging lawyers in Geneva. But India, for instance, has filed and won cases against the US. Voting in the WTO, as in the UN General Assembly, is 'one country, one vote'. But decisions are usually arrived at through informal consultation mechanisms.

MNC – Multi-national Corporation : An MNC, sometimes also called a TNC or Trans-national Corporation, refers to a corporation that has subsidiaries or branches, in more than one country. The branches may often be 100 per cent owned by the parent

corporation, but they may also be with minority investment. MNCs are general understood to be from developed countries, or rich countries. The oil majors, such as Exxon or BP (British Petroleum) and the automobile manufacturers, such as Ford, General Motors, Mercedes-Benz, Nissan or Honda. Recently, however, many MNCs have come from up the bigger middle income countries. India's Tata or China's Haier are examples of MNCs from rising economies.

IMF – International Monetary Fund : The IMF, along with the World bank, was set up at the Bretton Woods Conference in 1944, towards the end of the Second World War. The World Bank deals with development finance, the IMF's mandate is to manage international monetary, exchange rate and related global macro-economic matters. It serves as a type of lender of last resort for countries with balance of payments and other international payments problems. It describes itself an "an organisation of 187 countries (as of July 2010), working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty." Loans from the IMF usually comes attached with conditions about domestic monetary and fiscal policy. There is an unwritten convention that the head of the IMF will be a European, while that of the World Bank will be an American. At present, with the growing strength of the BASIC powers (Brazil, South Africa, India and China) there is a growing challenge to these conventions about the head of these organisations.

Cut-make-trim, or CMT : Refers to the task of final assembly or making of a garment, **cut** (the fabric), **make** (the garment) and add the **trim**. This is the final task in manufacturing a garment. It is labour-intensive and is now largely carried out in the labour-abundant economies of Asia, where labour is relatively cheap.

General Agreement on Trade in Services – GATS : This is the agreement on trade in services, which forms part of the WTO agreements. The preceding GATT did not have any agreement dealing with services. At that time, until the 1990s, there was not much trade in services. But over the last three decades or

so, trade in services has grown very substantially. GATS covers four kinds of trade in services. They are:

Mode 1 – Cross-border supply. Indian supply of IT and call centre services to USA, EU or other countries is a good example of cross-border supply of a service.

Mode 2 – Consumption abroad, such as tourism or international events, such as the Olympics or the Cricket and Football World Cups.

Mode 3 – Commercial presence. This is where a supplying company sets up an overseas branch to supply the services, as in banks (Citibank or Standard Chartered in India; or State Bank of India in the USA) or insurance companies (Lombard in India).

Mode 4 – presence of a 'natural person' as opposed to a corporate person. This in simple language is migration.

BPO Services – Business Process Outsourcing Services : This refers to the out-sourcing of various business services from one country to another. The well-known 'Call Centers' dealing with customer services, taking orders, or dealing with complaints are examples of BPOs. The provide a service from India for companies located elsewhere in the world. BPO services have expanded from the initial customer service related call centers, to encompass many business services – accounts, booking of tickets, managing payrolls, etc.

Remittances : These are the amounts of money sent from migrants working in one place to their families located somewhere else. There can be both domestic and international remittances. With the growth of migration, both domestic and international, remittances have become important to many economies. In the case of international remittances, they not only provide support for their families they also bring in valuable foreign exchange into a country. India's deficit in the balance of trade is almost entirely covered by remittances from Non-Resident Indians (NRIs) working in other countries.

Intellectual Property Rights– IPR : This refers to the ownership of a creation of the mind, which can be a technology,

discoveries and inventions; musical, literary and artistic works; words and symbols. The idea of intellectual property is two-fold: to express the moral and economic right of the author or creator; and to provide an incentive for the creation of new works, promote discoveries or inventions. When a person or a corporation has an exclusive right to use a discovery or invention, say a new medicine, then there can be a monopoly price for that product. This high price and the extra profit so earned is expected to provide an incentive for new knowledge and inventions. But knowledge is a public good, in that the consumption by one person does not reduce its consumption by another person. For example, one student's learning economics does not diminish any other persons knowledge of economics. On the contrary, we may argue that the more the knowledge of economics or anything by a large number of persons, the more likely is to be not only the spread but even the advance of knowledge. Consequently, there is a conflict between the incentive to make inventions and discoveries and the spread of knowledge. The high price of a medicine, say for treating cancer of HIV/AIDS, may lead to the inability of large numbers to not afford treatment. In such cases of public health or medial emergency, it has been ruled in the WTO, that countries may insist on compulsory licensing or production of generics.

Regional Trade : Refers to trade within a region, such as Europe, or Asia or parts of Asia. Regional trade has often led to Regional Free Trade Agreements (RFTAs). The best example of a RFTA is the European Union, within which all trade is free of tariffs and controls. The South-East Asian countries have the ASEAN Free Trade Agreement. Besides the factor of RFTAS, there is also the matter that regional trade is often of an informal cross-border type. With long land boundaries many commodities are traded between, say, Indian and Bangladesh and much of this trade does not enter into official records. Most regions or sub-regions are now covered by FTAs. This gives the economies the ability to use economies of scale in accessing each other's markets.

UNIT 15 INDIA'S EXPORT-IMPORT POLICY

Objectives

This unit helps you to understand:

- what is trade policy;
- kinds of trade policy;
- phases of liberalisation in trade policies in the process of economic development;
- trends in India's exim policies;
- salient features of India's import regime during 1950-91;
- characteristics of India's export promotion policies; and
- India's Trade Policy reforms in the 90s.

Structure

15.1 INTRODUCTION

Export-Import (EXIM) Policy alternatively known as Trade Policy refers to Policies adopted by a country with reference to exports and imports. Trade Policy can be free trade policy or protective trade policy. A free trade policy is one which does not impose any restriction on the exchange of goods and services between different countries. A free trade policy involves complete absence of tariffs, quotas, exchange restrictions, taxes and subsidies on production, factor use and consumption. Though free trade, theoretically, offers several advantages, in reality, particularly underdeveloped countries were at a disadvantage in such a system of international trade. As a result, in the early 20th century, international economy saw the emergence of protective trade policies.

A protective trade policy pursued by a country seeks to maintain a system of trade restrictions with the objective of protecting the domestic economy from the competition of foreign products. Protective trade policy constituted an important plank in the commercial policies of underdeveloped countries during the 50s, 60s and 70s and to some extent in the 80s. Many of the underdeveloped countries countinue to have protective trade policies even today.

Trade policies may be outward looking or inward looking. An outward looking trade policy encourages not only free trade but also the free movement of capital, workers, enterprises and students, a welcome to the multinational enterprise, and an open system of communications. An inward looking trade policy stresses the need for a country to evolve its own style of development and to be the master of its own fate, with restrictions on the movement of goods, services and people in and out of the country. An inward looking trade policy encourages the development of indigenous technologies appropriate to a country's resource endowment. Given these, a developing country may adopt commodity specific trade policies such as the following:

1. **Primary Outward Looking Policies:** Aimed at encouraging agricultural and raw material exports.
2. **Secondary Outward Looking Policies:** Aimed at promoting manufactured exports.
3. **Primary Inward Looking Policies:** Objective is to achieve agricultural self sufficiency.
4. **Secondary Inward Looking Policies:** Objective is attaining manufactured commodity self-sufficiency through import substitution.

Trade Policy will strongly influence the direction, trend and growth of foreign trade of a country. This, in turn, will have a bearing on the economic development process. Therefore, trade policy is an important economic instrument which can be used by a country, with suitable modifications from time to time, to achieve its long-term objectives.

15.2 INDIA'S EXIM POLICY : A BACKDROP

India's experience of the colonial past had a major influence on exim policy in the initial decades after independence. India's strategy towards trade policy was driven by perceived foreign exchange scarcities and the desire to ensure that scarce foreign exchange is used only for essential purposes for economic development. Industrialisation and self-sufficiency in essential commodities were the important objectives of India's trade policy. This was because it was felt that dependence on other, more powerful countries for imports of essential commodities would lead to political dependence on them as well.

This was succinctly brought out by the National Planning Committee (NPC) in 1946 set up by the Indian National Congress, under the Chairmanship of the late Jawaharlal Nehru.

> "In the context of the modern world, no country can be politically and economically independent, even within the framework of international interdependence, unless it is highly industrialised and has developed its power resources to the utmost. Nor can it achieve or maintain high standards of living and liquidate poverty without the aid of modern technology in almost every sphere of life. An industrially backward country will continually upset the world equilibrium and encourage the aggressive tendencies of more developed countries. Even if it retains its political independence, this will be nominal only and economic control will tend to pass to others."

Earlier the NPC had said that, "The objective of the country as a whole was the attainment, as far as possible, of national self-sufficiency. International trade was certainly not excluded, but we were anxious to avoid being drawn into the whirlpool of economic imperialism."

These laid the broad framework for the formulation of EXIM policy in the subsequent years. On the whole, import substitution and protection to domestic industrialisation through a system of tariff and non-tariff controls became the highlights of India's EXIM Policy for most of the period during 1950-51 to 1990-91, however, India's exim policy has undergone remarkable liberalisation, as part of the overall economic liberalisation process.

15.3 THE FOREIGN TRADE REGIME : ANALYTICAL PHASES AND CHANGES OVERTIME

J N Bhagwati and A Krueger, in their comparative analysis of the impact of foreign trade regimes and economic development in a number of countries, defined a set of analytical phases with reference to the EXIM policy of a country. These phases in the foreign trade regime were designed essentially as a classificatory and descriptive device to capture meaningfully the evolution of foreign trade regime in terms of its restrictionist content and the dimensions and pattern of its use of control and price instruments. There are broadly five phases which are as follows:

Phase I : Characterised by the systematic and significant imposition of quantitative restrictions (QR). It might start in response to an unsustainable balance of payments deficit. Throughout Phase I, controls are generally maintained and often intensified.

Phase II : Characterised by continued reliance upon quantitative restrictions and generally increased restrictiveness of the entire control system. Phase II is distinguished by two additional and related aspects of the QR system, both relatively unimportant during Phase I.

(1) The detailed workings of the control system become increasingly complex, and
(2) Price measures are adopted to address the functioning of the control system.

Both these characteristics of Phase II arise from dissatisfaction with the results of an undifferentiated system and are often the result of many small decisions rather than an overall policy design.

Price measures are introduced to both exports and imports. The continuation or intensification of foreign exchange shortage leads to the recognition that additional export earnings would be desirable. Rebate schemes, import replenishment schemes, special credits for exporters, and a variety of other devices may be instituted that offset part or all of the discrimination against exports implicit in an overvalued exchange rate. As for imports, price measures are also adopted to absorb part of the excess demand for imports. Tariffs may be increased or surcharges added to the cost of importing.

The following aspects of the price situation in Phase II are then evident :
(1) the exchange parity is overlaid by tariffs and subsidies, levied in lieu of formal parity change, (2) domestic currency is overvalued at the current parity plus trade tariffs and subsidies, implying a premium on imports.

Phase III : In this phase, attempts are made to systematise the changes introduced during the previous phase: It may consist of a mere "tidying-up" operation directed at replacing the diverse import premiums by reasonably uniform tariffs such that the differential incentive effects caused by diverse premiums on different imports are greatly reduced or virtually eliminated.

Alternatively, the tidying-up operation may replace the existing tariffs and export subsidies with a formal parity change, the result being that the effective exchange rates on exports and imports do not change much but the dispersion of tariffs is replaced by uniform devaluation.

On the other hand, Phase III may take the form of a devaluation cum liberalisation package. Such a package may have a gross devaluation large enough to leave a net devaluation despite the removal of trade tariffs and subsidies, and measures of import liberalisation.

Phase IV : The continued liberalisation in Phase III leads to the emergence of Phase IV. There will be consistent decline in QR and import tariffs. The effective exchange rate for exports will come closer to the effective exchange rate for imports.

Phase V : The transition into Phase V occurs when the exchange regime is virtually liberalised. There will be full convertibility on current account and quantitative restrictions will not be employed as a means of regulating the balance of payments. Thus, Phase V represents a total alternative to the QR regimes of Phases I and II. The pegged exchange rate will be at its equilibrium level and a flexible exchange rate policy will be in operation.

The application of these phases to the exim policies of India since independence would help to understand the policy developments in a proper perspective. Recently, T.N. Srinivasan has applied these phases for India's exim policy for the period ranging from 1950 to 1992.

Activity 1

Develop a case study for a hypothetical developing country which could pass through Phase I to Phase V (Analytical phases of Bhagwati and Krueger) in its foreign trade regime, in the process of economic development.

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15.4 INDIA'S EXIM POLICY : PHASES AND CHANGES

In the early fifties (1950-56) there was a rough equilibrium in the balance of payments, with import demand more or less equalling export earnings. During this period, there was no clear exim policy and import restrictions of any kind were not in use. The conditions were, more or less, similar to Phase IV.

In the second half of the fifties (1956-61), due to heavy industry oriented industrial planning, the rapid rise in imports put pressure on India's balance of payments. The Government imposed quantitative restrictions on imports. The quantitative restrictions were selective so as to encourage the development of particular industries through import licenses. Import substitution was stimulated while exports were not considered a line of activity to be stimulated. Thus, this period resembled the characteristics of Phase I.

In the early sixties (1961-66) quantitative restrictions for imports continued. At the same time, efforts were made to boost exports by creating a favourable atmosphere to export industries, diversification of export markets and the development of export support services. Export subsidisation was introduced in 1962 primarily to offset the penalties that quantitative restrictions imposed, in effect, on exports. This period could be classified under Phase II.

The economy entered Phase III in the second half of the 60s (1966-68) with a devaluation in June 1966 to systematise and rationalise the export incentive system. At the same time, export subsidies were reduced, export duties imposed, and import duties were reduced. The net devaluation after allowing for these changes was, on an average, less than the gross devaluation of 57.5 percent and varied among commodities. According to Bhagwati and Srinivasan, the total net devaluation on the trade account was 21.6 percent for exports and 42.3 percent for imports. Consequently, the net effect was a further stimulation of import substitution over export production.

At the end of sixties up to the mid seventies (1968-75) the hesitant steps towards liberalisation introduced with devaluation were abandoned. The country moved back to Phase II. Export subsidies were reinstated and augmented. Import policy became increasingly restrictive and complex. This was due to various shocks which the economy experienced such as (1) refugee inflow due to Bangladesh war in 1971 (2) stagnant agricultural production resulting out of adverse weather conditions, (3) oil-price hike-shock of 1973, etc.

The scarcity of foreign exchange became more acute. A new set of restrictive measures for imports was introduced every year. Import allocation criteria became more complex. Tariff rates escalated gradually.

The foreign exchange reserves position improved in the latter of the 70s, due to:

- increased remittances from Indians working in West Asia;
- improved agricultural production; and
- decline in public investment.

The net result was a relaxation in the severity of import control regime during 1975-85, signifying the re-entry into Phase III. Import allocation rules were made simpler. Protective quotas, however, remained intact and domestic industry continued to be completely shielded from import competition.

In April 1985, in a significant departure, the Government announced new Export-Import Policy for a period of three years. The objective was to bring some stability to the policy and thereby reduce the uncertainty about year to year changes that exporters and importers faced. However, in reality, this did not restrain the Government from announcing changes in the exim policy from time to time.

Although the stringency of the import regime did not dilute substantially, the two three-year policies (i.e., Exim policies of 1985-88 and 1988-91), did represent some major simplifications. In particular, the number of items in the category of Open General Licence (OGL) for capital goods imports increased from nil in 1975 to over 1,100 items in the 1988-91 policy. Similarly, many intermediate goods were put in the OGL category. Thus policy changes that occurred in the latter half of the 80s till 1991 (1986-91) characterised the continuance of Phase III, which began in 1975.

However, it was since 1991 that radical changes were introduced in India's exim policy. There has been a gradual and steady curtailment of import tariffs

and liberalisation of quantitative restrictions. The rupee has been made almost fully convertible on the current account. There are indications that the rupee will be made convertible on the capital account within a definite time period. All these signify that India has entered Phase IV with regard to the foreign trade regime.

Broadly, India's trade policy can be aggregated into essentially two categories:

(i) Those that are associated with inducing import substitution as well as those that are import repressive or import rationing, and

(ii) Those that influence the level and composition of exports of goods and services.

Over the years, trade policy has undergone fundamental shifts to correct the earlier anti-export bias through the withdrawal of quantitative restrictions (QRs), reduction and rationalization of tariffs, liberalization in the trade and payments regime and improved access to export incentives, besides a realistic and market based exchange rate.

15.5 INDIA'S IMPORT REGIME (1950-89) : MAJOR FEATURES

India's import regime had two major kinds of protective barriers: (i) Non-tariff controls and (ii) Tariffs.

Non-Tariff Controls: Non-tariff controls were the principal means of regulating imports and protecting local industries. These controls till the 90s included the (a) import licensing system, (b) canalisation, (c) actual user policy and (d) phased manufactured programmes.

a) **Import Licensing System:** This system devides imports into three categories:

1. Consumer goods
2. Capital goods
3. Intermediate raw materials, components, spare parts and supplies.

Imports of consumer goods are generally banned, excluding those which are imported by canalising agencies of the Government. These products may be judged by the Government as essential on the grounds that they are not produced locally or domestic production is insufficient to meet the local demand. e.g.: edible oil, certain drugs and medicines, kerosene, and food grains.

Capital goods are divided into a "restricted category" and an "Open General Licence" (OGL) category. OGL capital goods can be imported without a licence, provided the importing firm is the actual user of the machinery. An import license is required for the import of any item on the restricted list and also for any item not on the OGL list, even if it is not on the restricted list.

Finally, intermediate goods imports are divided into banned, restricted, limited permissible and OGL categories. Intermediate goods that are not on the first three lists, nor on the separate lists of canalised items, could be imported without a licence.

b) **Canalisation:** Canalising agencies are another means through which the Government exercises control over imports. These organisations are the sole importers of products listed in the EXIM Policy. The most important canalised products and the respective agencies are given in Table 15.1.

Table 15.1: Canalisation : Items and Agencies

Item	Canalising Agency
1. Crude Oil, and Petroleum Products	Indian Oil Corporation (I.O.C.)
2. Iron and Steel, non-ferrous metals and fertilisers	Minerals and Metals Trading Corporation (M.M.T.C.)
3. Edible oils, natural rubber, Sugar, news print, and Cement	State Trading Corporation (S.T.C.)
4. Scrap Metal	Metal Scrap Trading Corporation (M.S.T.C.)
5. Cereals	Food Corporation of India (F.C.I.)
6. Cotton	Cotton Corporation of India (C.C.I.)

Canalised importers account for a significant share in total imports including Petroleum, Oil and Lubricants (P.O.L.). Policies on the importing, pricing and distribution of the most important canalised products are determined and supervised by the concerned ministries or departments and others by two committees chaired by the Chief Controller of Imports and Exports. The activities of the canalising agencies are an integral part of the system of non-tariff discretionary controls over imports.

c) **Actual User Policy:** This policy disallows imports for resale by excluding intermediaries from importing. The policy was introduced in the early 70s and became complete in April 1977 with the abolition of the category of "Established Importers" who were earlier eligible for import licenses. As per this policy, only the actual user of a capital good or intermediate products be allowed to import such goods, through import licenses.

d) **Phased Manufacturing Programme (P.M.P.):** As per PMP, the concerned firm agrees to progressively replace imported materials, parts and components with materials, parts and components produced in-house or by other Indian firms. The PMPs accompany industrial licences in a wide range of industries involving assembly of parts and components notably, vehicle, machinery and electronics industries.

In order to ensure that a firm sticks to PMP, the import of all parts and components by that firm requires prior clearance by the sponsoring authority for the industry, which attests that the imports are not included in the list of products that should be locally sourced under the PMP. The PMP procedures, therefore, amount to a separate set of quantitative import controls which apply to many intermediate products, including those which appear on OGL lists, and which in theory are importable without restriction. Moreover the controls continue to remain in force, since once the required level of indigenisation is achieved, surveillance continues to ensure that firms do not reduce the agreed indigenisation levels.

Tariffs: The tariffs consist of:

(a) basic customs duties, mostly *ad valorem*, applied to the c.i.f. price of the import.

(b) an auxiliary duty applied to the c.i.f. price, and

(c) additional duties equivalent to excise taxes imposed on locally produced products, applied to the c.i.f. price plus the basic customs duty and auxiliary duty.

The basic *ad valorem* duties range from zero to 300 percent; the general auxiliary duty is 40 percent. The tariff schedule appears very simple, with quite uniform basic customs duties. But in practice, tariff based protection is extremely complex, owing to a large number of exemptions for various products for all three components.

It is difficult to generalise the level and structure of tariffs because of various kinds of exemptions. However, the general level of duties was extremely high absolutely as well as relatively, before allowing for exemptions, (Table 15.2).

Table 15.2: Tariff Levels in India and other Developing Countries (Nominal Tariff Rates, 1985)

(% of value)

Country	Intermediate Goods	Capital Goods	Consumer Goods	Manufactured Goods
Hungary	14.2	15.0	22.6	20.9
Yugoslavia	18.0	20.7	20.0	19.0
Argentina	21.2	25.0	21.9	22.9
Morocco	21.6	18.1	43.0	27.3
Philippines	21.8	24.5	39.0	28.0
Mexico	25.5	23.5	32.2	24.7
Thailand	27.8	24.8	8.5	33.6
Turkey	29.4	54.9	55.3	37.1
Pakistan	75.0	73.8	127.3	89.8
China	78.9	62.5	130.7	91.2
Bangladesh	97.9	80.5	116.1	100.8
India	146.4	107.3	140.9	137.7

Source: "India Survey", *The Economist,* May 4 – 10, 1991.

Indian tariffs were much higher than tariffs in other developing countries : average Indian tariffs for intermediate, capital and consumer goods as well as for manufactured goods as a whole were much higher than in other countries.

15.6 EXPORT POLICIES AND INCENTIVES (1950-89)

Exports are subject to a licensing regime to serve a variety of objectives. A number of primary and some manufactured products are subject to export restrictions of varying intensity so as to control domestic prices. The export controls are also used to implement canalisation of some exports, to regulate exports of products subject to quotas in importing countries, to ensure minimum export prices, etc. However, the main thrust of export policies has been to promote and not to restrict exports. Further, since 1976, export taxes which were previously applied to 25 commodities were steadily removed.

In addition, the Government had recognised that manufacturers exporting to the highly competitive world market would have to be provided incentives to offset the higher cost and other disadvantages of operating in the protected and controlled domestic market. Accordingly, a wide variety of export incentives and institutions have been established.

Indian Policy incentives to promote exports can be broadly classified as under :

1. Special facilities to make the material inputs needed by exporters available, at reduced cost.
2. Free Trade Zones and Export Oriented Units.
3. Facilities for making capital equipments available, at reduced rate.
4. Incentives for and assistance with export marketing.
5. Profit tax and credit subsidies and
6. Subsidies on domestic raw materials.

Over a period of time, the Government has steadily increased and extended these incentives.

1. Special Facilities for Material Inputs

Availability of qualitative raw materials in sufficient quantity and at the right time, at competitive prices, is crucial for export growth. In India this was ensured through special import licences for exporters (known as replenishment (REP) and imprest licences) combined with duty drawback and cash compensation.

The REP and imprest licences allow the exporter to import certain restricted raw materials and components, upto a specified percentage of specified exports. The imports pay normal customs duties, but refunds can be claimed through the duty drawback scheme.

Imprest licences are issued on the basis of export contracts or on past export performance, and the materials must actually be used in exports. REP licences are issued against actual exports after they have taken place, and to the extent that imported materials are not required, the REP entitlement can be legally sold on the open market.

The duty drawback scheme allows the refund of excise, sales and other indirect taxes (apart from customs duties) included in the cost of domestically purchased raw materials. This is supplemented by the cash compensatory support (CCS) scheme, which compensates the exporter for other domestic taxes such as excise duties and sales taxes included in the cost of electricity.

Import-Export Pass Book

The scheme which was introduced on 1st January 1986, continued by EXIM Policy, 1988-91. Its aim was to streamline the import procedure for exporters by providing duty-free access to imported inputs for exporters of manufacturers. The scheme was wider in scope and more flexible than the previous advance licensing scheme.

Imports used for export production were exempted from customs duty as well as from additional duties on imports for an exporter holding Import Export Pass Book including import licence. The pass books is applicable only to registered manufactured exporters.

2. Free Trade Zones and Export Oriented Units (EOU)

Free Trade Zones or Export Processing Zones (EPZs) and EOUs are the other means which Government has adopted to promote exporters.

The rationale for establishing EPZs is that export production can be initiated without adjusting or transforming the regime of protection for companies producing for the domestic market. EPZs are treated as operating outside the domestic tariff area, and hence have the right to import all their requirements,

including capital goods and spare parts as well as raw materials, free of import licensing controls and import duties.

India was the first developing country to establish an EPZ. In 1965, one such zone was established in Kandla while in 1974 a second zone was set up — the Santa Cruz Electronic Export Processing Zone (SEEPZ) near Bombay. In 1983, a decision was taken to create four more EPZs, which came up subsequently : Madras, Kochi, Noida, near New Delhi and Falta, Calcutta.

An EPZ creates a free trade environment allowing for duty free imports of capital goods and intermediate inputs and tax free exports of manufactures. It overcomes the problem of administrative control and bureaucratic intervention. Ultimately, the objective is to attract foreign companies to establish export units.

The Export Oriented Units (EOU) scheme was implemented in 1981 to provide duty-free access to imports of all inputs for such export oriented companies and to create a single point clearance with regard to industrial licensing and foreign collaborations. A company is required to fulfill three conditions to be eligible as an EOU :

(a) its output should entirely be exported,

(b) the domestic value added content of the export value should be 20 percent at least; and

(c) export production should be under a custom bond for 10 years for products facing rapid technological change.

The contribution of EPZs and EOUs to India's exports, however, is only limited and has not made any significant progress either.

3. Availability of Capital Equipments at Reduced Rates

The liberalisation of imports of capital goods and associated tariff reductions was introduced in 1976. The objective was to make specialised and upto-date machines available and less expensive for export oriented industries such as leather, garment, hosiery, seafood, woolen textile and diamond processing industries. In 1986, the policy was broadened to other export potential industries.

4. Export Marketing

From an early stage, Government has recognised that marketing of exports is generally a more difficult task than selling in the domestic market. Many small and medium firms and even many large firms, by Indian standards, may not be able to market their products on their own, in the international market. Therefore, the Government allowed for the first time in 1960, the coming up of export houses. In 1981, in emulation of Japan and South Korea, it encouraged the development of larger trading houses.

In 1963, an Export Inspection Council (EIC) was established whose function is to conduct pre-shipment inspection to prevent the export of inferior quality products.

Over a period of time, the Government has also promoted 18 industry specific Export Promotion Councils: Apparel Export Promotion Council — to promote garment exports, Engineering Export Promotion Council — to promote engineering goods exports, etc. The Trade Development Authority (T.D.A.) and Trade Fair Authority of India (T.F.A.I.) were the other agencies promoted by the Government for export promotion. [In 1994, T.D.A. and T.F.A.I. were merged to form Indian Trade Promotion Organisation (I.T.P.O.)]. All these fall under the purview of the Ministry of Commerce.

5. Profit Tax and Credit Subsidies

Exporters had received, in one form or another, profit tax concession since the early 1960s. There were also provisions for preferential pre-shipment and post-shipment credit. The formation of EXIM Bank in the early 80s marked another significant development towards improved financial flow for exporters. Export credit guarantees for banks and credit insurance for exporters are available from the Export Credit Guarantee Corporation (ECGC).

6. Subsidies on Domestic Raw Materials

There are also schemes for refunding to exporters the difference between the domestic and world prices of Indian materials. The most important is the International Price Reimbursement Scheme (IPRS) for steel. The scheme was introduced in 1981. In 1986 this scheme was extended from basic steel products to alloy steels. There are also similar subsidy schemes, i.e., for other import raw materials such as aluminium and copper.

Performance of EXIM Policies (1950-1989)

A review of the main elements of India's system of import controls and export incentives shows that in the course of time, the exim policies have undergone fluctuations in terms of stringency for import control, and have become increasingly comprehensive for export promotion. Of course, this does not mean that the policies have become fully effective in terms of the stated objectives.

The shrinking share of India's exports in world exports, the relatively low share of India's trade in GDP, widening trade deficit, growing external debt, continued deficits on current account which, in turn, among others, led to the balance of payments crisis in 1990/91 etc., show that India's exim policy till the 90s, did not make any significant contribution to the growth of its external sector on desired path. India could neither achieve self-sufficiency nor could its industry become internationally competitive. Industry suffered from technological obsolescence and high cost due to prolonged protection from both internal and external competition.

15.7 EXIM POLICIES IN THE 90s

EXIM Policy, 1990

After terminating the Exim Policy for 1988-91 a year in advance, the Government announced on 30th April, 1990 a new Exim Policy. The Policy statement said : "Improvement in our Balance of Payments position can be achieved not so much through import curtailment as through promotion of exports". The Policy provided further momentum to exim policy liberalisation:

1. The OGL list was expanded to facilitate easy access to import of items, not available within the country.
2. A scheme of automatic licensing was introduced under which upto 10 percent of the value of previous year's license could be imported.
3. A scheme of Star Trading House was introduced for exporters with an average annual net foreign exchange earnings of Rs. 75 crore in the preceding three licensing years of the base period. Star Trading Houses are eligible for grant of special additional licenses calculated at the rate of 15 percent of net foreign exchange earned in the preceding year.
4. Under the Duty Exemption scheme, Blanket Advance Licensing has been introduced for manufacturer-exporters having a minimum foreign exchange earnings of Rs. 10 crore in the previous three yeas.
5. The Import-Export Passbook Scheme introduced in 1986 was withdrawn.

EXIM Policy Changes in 1991

In response to the balance of payments crisis in 1990/91, India launched a programme of economic reforms in June 1991. The economic reforms comprised wide ranging changes in trade policies, apart from industrial policies, etc.

High tariff walls and strict import licensing resulted out of the earlier policies had produced a domestic cost structure which was out of line with the world prices. To redress this situation and to augment exports which is crucial to the medium term recovery of the economy, adjustments in the exchange rate of the rupee were effected twice in July 1991. These adjustments are aimed at improving India's competitiveness in the world market and thereby boost exports. These exchange rate policy changes were followed by structural reforms in trade policy aimed at substantial liberalisation of controls and licenses, decanalisation of many items of trade, reduction in peak tariff rates, abolition of export subsidies and other measures.

It was during July-August 1991 that the Government announced far reaching changes in trade policy. These policy changes aimed at strengthening export incentives, eliminting a substantial volume of import licensing and optimal import compression. Essential imports of sensitive items (such as POL and fertilisers) were fully protected, but other imports of raw materials and components were linked to export performance through enlargement and restructuring of the replenishment licensing system. The system of cash compensatory support was abolished consequent upon the change in exchange rate and other measures of reform which provided substantial incentives for exports across the board.

The major policy changes introduced are :

1. The new trade policy made major changes in the import licensing system by replacing large part of administered licensing of imports by import entitlements linked to export earnings. The import replenishment system was enlarged and restructured and renamed as Eximscrips. Eximscrips are freely tradeable and the premium on the scrips, set by the market, represented a further incentive to exporters and a means of allocating imports according to market forces.
2. The system of advance licences, designed to provide exporters with duty free access to inputs, was strengthened further by simplifying and speeding up the process of issuing these licenses.
3. The procedure for import of capital goods was simplified following the Industrial Policy, 1991. New units and units undergoing substantial expansion would be automatically granted licences for import of capital goods without any clearance from the indigenous availability angle, provided their import is fully covered by foreign equity or the import requirement was upto 25 percent of the value of plant and machinery subject to a maximum of Rs. 2 crore.

   Import of OGL capital goods, non-OGL capital goods and Restricted goods would be allowed without a specific licence, provided clearance was given by the R.B.I. and foreign exchange for their imports are fully covered by foreign equity.
4. Foreign equity upto 51 percent in Trading Houses permitted, with all the benefits available to domestic export and trading houses.
5. The new trade policy aimed at progressive decanalisation. The Government decontrolled 116 items allowing their exports without any licensing formalities. Another 29 items shifted to OGL. In the case of imports, 6 items decanalised and placed on OGL while 16 items decanalised and listed in Appendix 3, where they will be available for import against Eximscrips.

6. Since EPZs/EOUs have not taken off as expected, the policy introduced several changes to promote them further. A significant new policy measure was that Domestic Tariff Area (DTA) sales was permitted in the ratio of 25 : 75 in relation to export sales in case of units whose use of indegenous raw material is more than 30 percent of production. In all other cases, the ratio of permissible DTA sales to export sales will be 15 : 85. By another policy measure, the International Price Reimbursement Scheme (IPRS) for supply of steel was extended to EPZs and EOUs.
7. The new policy abolished the Actual User requirement in respect of OGL capital goods and OGL raw materials and components.
8. The phased Manufacturing Programmes was abolished for new projects, and subsequently, for existing projects as well.
9. The trade policy indicated that customs duties would be reduced overtime, in tandem with improvements in the fiscal and balance of payments position. The peak tariff rates were reduced to a maximum of 150 percent from as much as 300 percent or more and a moderate across the board reduction in tariff on capital goods imports

EXIM Policy (1992-97)

On 31st March 1992 a new five year export-import policy was announced. This gave a further push to liberalisation by freely allowing imports of all items except a negative list, decanalising a large number of raw materials and further liberalising import of capital goods against export obligation:

- Import of all items including capital goods are freely allowed. The negative list will contain consumer goods, barring 28 specific items, and 70 other items, whose imports would be restricted.
- Import of a number of items including newsprint, non-ferrous metals, natural rubber, intermediates and raw materials for fertilisers decanalised. Petroleum products, edible oils, fertilisers and cereals continue to be on the canalised list.
- Exports of all items are free except a negative list.
- The scope of duty exemption scheme has been enlarged by introducing value based advance licenses besides the quantity based advance licences.
- Export houses, trading and star trading houses to be eligible for self certification under the advance license scheme which permits duty free imports for exports.
- The export promotion capital goods (EPCG) scheme liberalised further. Under the scheme, import of capital goods was permitted at 25 percent import duty subject to export obligation of three items the C.I.F. value of imports to be achieved over a period of four years.
- Keeping in view the important role played by the export promotion councils, exporters will continue to register themselves with these bodies. The registration-cum-membership certificates (RCMC) will continue to be an essential requirement for any importer or exporter to avail the benefits or concessions or to apply for any license.
- Under the new policy, certain categories of exports and exporters are eligible to receive special import licences.
- A significant aspect of the new policy is that amendments will be made once a quarter.

Thus the Exim Policy (1992-97), further accelerated the process of trade policy reforms.

EXIM Policy Changes (1992-93)

1. Liberalised Exchange Rate Management System (LERMS)

A new system of exchange rate management was introduced. As per this system, forty percent of the proceeds of exports and inward remittances was purchased at the official exchange rate by the Reserve Bank of India (R.B.I.) for official use. All other receipts and payments are converted at the market exchange rate. Receipts and payments on capital account continued to be subject to controls.

Imports under advance and imprest licences and replenishment imports against gems and jewellery exports were paid at official exchange rate to the extent of 40 percent of the import value. R.B.I. can enter the free market and intervene at its discretion. EPZs and EOUs were allowed to convert all their exchange earnings at the market rate.

The foreign exchange surrendered at the official exchange rate was utilised to import essential items. All other imports of raw materials, components and also capital goods are made freely importable on OGL but foreign exchange for these imports has to be obtained from the market.

The new system was introduced as a transitional arrangement towards a unified exchange rate with current account convertibility. The system simplified the trade policy by eliminating detailed exchange control.

2. Import Licensing Liberalisation

The introduction of LERMS led to abolishing eximscrips as LERMS made all capital goods, raw materials and components freely importable subject to tariff protection and the imports have to be paid by obtaining foreign exchange from the market. In April, 1992 the negative list of licenceable imports was pruned substantially : three import items banned, 71 items restricted and seven items canalised.

Under the new system, exporters benefited from the higher market rate obtained by surrendering 60 percent of the foreign exchange earned at market rates instead of the premium earlier available in eximscrips.

3. Export Promotion Capital Goods (EPCG) Scheme

The scheme was further liberalised to allow imports of capital goods at a lower concessional customs duty of 15 percent subject to an export commitment equivalent to four times the C.I.F. value of imports to be achieved over a period of five years.

4. Improvements in Advance Licensing

A system of value-based advance licences has been introduced. This permits duty free imports of necessary raw materials and components upto a stipulated percentage of the value of indicated exports. Physical quantities and norms are not laid down for individual inputs. Self-certification advance licences are available for Export Houses, Trading Houses and Star Trading Houses.

5. EPZs/EOUs

These schemes have been liberalised and extended to agriculture, horticulture, acquaculture, poultry and animal husbandry. EPZ units and EOUs can sell upto 25 percent of their output in the domestic market on payment of duty and as long as the product is allowed to be imported.

6. Special Import Licences (SILs)

Certain categories of exports and exporters are eligible for SILs in order to enable them to import specified items which are on the restricted list. These licences would be freely tradable in the market.

7. Tariff Rationalisation

The Government, following the recommendations of Tax Reforms Committee, reduced the peak level of tariff to 150 percent in 1991-92 and further to 110 percent in 1992-93. Further, import duties on capital goods, project imports, basic feed stocks for petro-chemicals etc., were brought down.

Thus, the trend of trade liberalisation gained further momentum by 1993.

EXIM Policy Changes (1993-94)

In 1993-94, the EXIM policy gave a new thrust to exports for agricultural and allied sectors, and services in which the country has comparative advantage. Further reduction in customs duties, decanalisation, pruning of negative lists, expansion of the definition of capital goods, etc. are the other major features:

- Imports of Kerosene oil. Liquid Petroleum Gas (LPG), Low sulphur heavy stock/low sulphur waxy residue amongst petroleum products and phosphatic and potassic fertilisers are decanalised.
- EOUs engaged in agriculture and allied activities permitted to avail duty-free capital goods imports, even if they export only 50 percent output.
- Negative list of exports pruned by removing 146 items.
- A new EPCG scheme introduced for the services sector which permits import of capital goods at 15 percent import duty.
- Definition of capital goods enlarged to include sectors like agriculture, mining and services, apart from manufacturing.
- Change in the criterion for recognition as an export or trading or star trading house from net foreign exchange earned to gross f.o.b. value of physical exports. The award of Special Import Licences for these houses as well as for the electronic sector will also be based on this criterion.
- The maximum import duties were reduced from 110 percent to 80 percent. There were substantial reductions in customs duties on capital goods, ferrous and non-ferrous metals and chemicals.
- But the most significant development was the step towards current account convertibility taken in March 1993. The transactions on trade account were freed from exchange control. The determination of the exchange rate of the rupee was left to the market.

Thus, exim policy changes in 1993-94 gave a further fillip to the liberalisation process of trade regime.

EXIM Policy Changes (1994-95)

To promote exports and simplify import procedures, the following measures were taken during 1994-95 :

- Third party exports were given benefits under EPCG scheme.
- Scope of items importable under the Special Import Licenses (SILs) was increased.
- A new category of Super Star Trading Houses was created, which are entitled to membership of apex consultative bodies concerned with trade policy and promotion.
- Second hand capital goods with a minimum residual life of over 5 years were made fully importable by actual users.
- The peak customs duty rate was brought down to 65 percent. The reductions in import duty were especially sharp for capital goods.

EXIM Policy Changes (1995-96)

- The definition of consumer goods has been changed to suit the needs of importers, so as to allow them to freely import parts, components and spares of consumer goods as well. These were earlier restricted to the extent that these could be imported without a licence only by actual users. With the changes made, any person can import parts or components of consumer durables freely, without a licence and without actual user condition.
- The list of freely importable consumer goods has been further expanded to include 78 items.
- The list of goods permitted to be imported under SILs has been expanded further.
- An alternative route of the Pass Book Scheme for some categories of exporters has been opened. Basic customs duty credit is allowed to be given upon exports. These credits may be utilised for payment of customs duty against imports of non-negative items.
- The customs duty peak rate was lowered further along with import tariff reductions on various items.

In 1996-97, to accelerate the pace of reforms, the Exim Policy has been reviewed and revised in several ways. The objective is to further phase out quantitative and qualitative restrictions. A number of items from the negative/ restricted list has been permitted free for import and many others have been shifted to the list of items which can be imported under SILs. The peak customs duty rate was reduced to 50 percent.

The Union Budget (1997-98), further brought down the tariff rates on imports. The peak customs duty has been reduced to 40 percent. The duty on capital goods came down to 20 percent. Plans, designs and drawings have been completely exempted from customs duty. In addition, there are customs duty cuts on a wide range of commodities.

EXIM Policy Aligned on ITC (HS) Classification

Another significant development on the trade policy front in the 90s is that the exim policy has been aligned on the Harmonised System of Commodity classification. The Harmonised System (HS) of commodity classification, developed by the Customs Cooperation Council (CCS), Brussels has been in use the world over since the late 80s. India has adopted the system for Customs, Excise, Drawback and compilation of foreign trade statistics purposes. The first attempt to introduce the same system in the trade sector was made with the publication of Import Licensing Policy in two volumes in October, 1991. However, the radical changes in EXIM Policy (1992-97), reduced the utility of the document. The entire exercise was thereafter taken up afresh at the eight digit extended HS level, and the new Indian Trade Classification (ITC) has been brought out by 1996, with the following objectives :

1. Greater transparency in the import and export licensing policy.
2. Compatibility with the system of classification followed by Customs, Central Excise and the DGCI & S on Harmonised System of commodity classification.
3. Reduction in discretionary controls and areas of ambiguity and disputes on import policy matters.
4. Development of the basic module for computerisation and Electronic Data Interchange (EDI).

Activity 2

Meet an exporter located in your district and discuss the positive features of India's current exim policy. Prepare a note.

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15.8 EXPORT-IMPORT POLICY (1997-2002)

On 31st March, 1997 a new five year Exim Policy was announced. The policy carried further the process of trade liberalisation. The new Exim Policy has cut down the list of quantitative restrictions on imports, simplified procedures, reduced multiplicity of schemes, provided special incentives for agro and allied sectors and encouraged domestic sourcing of inputs. Some of the major features of the new Exim Policy are:

- The policy shifted 542 items out of the restricted list to the Special Import Licence (SIL) and OGL lists.
- About 60 items shifted out of SIL to OGL.
- About 150 items can now be imported against SIL.
- The policy has done away with the Value Based Advance Licence Scheme (Vabal) and passbook scheme and introduced a new duty entitlement Pass Book scheme.
- Under this scheme, the exporters will be issued a Pass Book. If he seeks this on pre-export basis, he would be given adhoc duty entitlement calculated at 5 percent of average f.o.b. value of exports in the preceding three years. This entitlement would enable him to import required inputs duty free.

On post-shipment basis, exporter shall be entitled for duty-free credits at notified rates. He can make use of this to import any freely importable item.

- The policy has revised the threshold limits of export obligation for the different categories of export/trading houses. The previous threshold limits and revised threshold limits for recognition alongwith SIL entitlement are presented in Table 15.3.

Table 15.3 : Export Obligation

(Rs. in crores)

	Export House	Trading House	Star Trading House	Super Star Trading House
F.O.B. 3 year average	20 (10)	100 (50)	500 (250)	1500 (750)
Net Foreign Exchange (N.F.E.)	16 (6)	80 (30)	400 (125)	1200 (400)
F.O.B. preceding year	30 (15)	150 (75)	750 (300)	2250 (1000)
Net Foreign Exchange preceding year	24 (12)	120 (60)	600 (150)	1800 (600)
SIL (%) F.O.B. basis	6 (4)	8 (5)	10 (6)	12 (11)
SIL (%) NFE basis	7.5 (6)	10 (8.5)	12 (11)	15 (16)

**Figures in brackets present previous limits.*

- Quantity based advance licence scheme (Qabal) will continue.
- The duty payable under the Export Promotion Capital Goods (EPCG) scheme has been reduced from 15 percent to 10 percent.
- EOUs/EPZ units in the agro sector will be allowed to sell 50 percent of their output in the Domestic Tariff Area (DTA) without stipulation of any value addition. These units are allowed to import equipments of Rs. 5 crore and above under zero duty EPCG scheme.
- The Special Import License (SIL) entitlement of exporters holding ISO 9000 series has been increased from 2 percent of f.o.b. to 5 percent of f.o.b.
- The export obligation period under advance licence has been enhanced from 12 months to 18 months and similarly the validity of advance license has been enhanced from 12 months to 18 months.
- The value limit for advance licence under production programme basis has been increased from 25 percent of average f.o.b. value of exports to 100 percent of average f.o.b. value of exports so that an exporter could obtain advance license at one go for his requirements and need not go to the Regional Licence Authorities again and again.

The Exim policy has been welcomed by the industry in general and exporters in particular. The simplification of procedures, reduction in duties, pruning of negative list, incentives to promote exports, etc. together are directed to step up the growth of exports.

15.9 EXPORT-IMPORT POLICY (2002-07)

The new Export and Import (EXIM) Policy framed for the period 2002-07 and unveiled on 31 March, 2002 also seeks to usher in an environment free of restrictions and controls (Annexture I). Synergy between these policies/ strategies is expected to realize India's strong export potential and enhance the oveall competitiveness of its exports.

The Policy measures announced in the Union Budget 2002-03 included a comprehensive package for development of Special Economic Zones (SEZ) including entitlement by these Zones to procure duty free equipment, raw materials, components, etc. whether imported or purchased locally, further decontrol and deregulation of agriculture sector to encourage higher exports of farm products (with measures like decanalisation of export of agricultural commodities, phasing out of remaining export controls, setting up of more Agri-Export Zones in various states and enhanced incentives for export of food grains), de-reservation from small scale industry (SSI) provisions for over 50 items (of knitwear, selected agricultural implements, chemical & drugs and others) to facilitate higher investment, technology upgradation and exports from these sectors and fiscal measures for strengthening certain key industries (includng textiles, steel, non ferrous metals and IT industry) for improving their competitiveness and exports. The Budget announced a reduction in peak customs duty from 35 percnt to 30 percent and also provided an indication of further reductions/rationalization in these duties into only two slabs of 10 percent (for raw material, intermediate and components) and 20 percent (for final products) by 2004-05. A detailed roadmap has been recommended by the Finance Ministry Task Force on Indirect taxation for, *inter alia,* further reforms in areas related to customs tariffs, rationalization of export promotion schemes, trade facilitation and other changes in tax administration (Annexure II).

15.10 TRADE POLICY REFORMS

It is now widely acknowledged that major reforms in trade policy and procedures since the EXIM Policy (1992-97) announced in 1992, have stepped up the transitional process of Indian economy towards globalisation by encouraging exports and permitting imports of essential inputs as well as capital goods.

A major objective of the EXIM Policy (1992-97) and the subsequent changes introduced during the last five years was to phase out quantitative restrictions in the form of licensing and other discretionary controls. Another significant objective was to continuously scale down the tariff barriers. To a large extent, these objectives have been met :

- In 1991, imports were regulated by means of a positive list of freely importable items. Since 1992, imports are regulated through a limited negative list, which has been consistently pruned year by year.

- Quantitative restrictions on imports of most intermediate inputs and capital goods have been eliminated.

- In July 1991, out of 5021 Harmonised System (HS) tariff lines (6 digits), 4000 lines were subject to import licensing restrictions. As of December 1995, more than 3000 tariff lines covering raw materials, intermediates and capital goods are free of import licensing requirements.

- A large number of items covering 1487 tariff lines whose import is otherwise restricted, are now allowed to be imported under freely tradable Special Imports Licences.

- Customs duty rates have been substantially cut down across the board, from apeak of 300 percent in 1990 to a peak of 40 percent in 1997.

The focus of these reforms has been on liberalization, openness, transparency and globalization with a basic thrust on outward orientation focusing on export promotion activity and improving competitiveness of Indian industry to meet global market requirements. In early 2002, the Government presented a Medium Term Export Strategy (MTES) for 2002-07 providing a vision for creating a stable policy environment with indicative sector-wise targets, with a mission to achieve one percent of global trade by 2007.

All these clearly shows that India is consistently marching towards globalizatioin by opening up its economy, by removing the importers as well as exporters from the clutches of unwanted controls and regulations and also by bringing down the tariff rates to that level comparable to international standards.

15.11 SUMMARY

India's trade policy has undergone remarkable changes since 1950-51. The objectives of achieving self-sufficiency, protecting domestic industry and balance of payments problems prompted the country to go for stringent import control regime through quantitative and non-quantitative restrictions. In the process, competitiveness of domestic industry suffered severely. Export promotion policies could not bring any significant turnaround in export growth so as to exceed imports. Consequently, balance of payments situation did not improve either. Rather, it only deteriorated in the late 80s, culminating in a crises in 1990-91.

The 1990-91 crisis led the country to adopt altogether a different strategy on the trade policy front, as part of its economic reforms. Since 1991, radical changes have been introduced in the trade policy through substantial removal of quantitative and non-quantitative restrictions, gradual but consistent reduction in tariffs, convertibility of rupee on current account, increased thrust on export promotion measures through infrastructural support, etc. All these have opened up the economy to international competition considerably. Though there has not been any significant change on the trade balance front, the overall balance of payments position has become comfortable since 1991. However, significant export growth in the range of 15 to 20 percent per annum, in dollar terms, has still remained a distant reality. Development of infrastructure such as power, telecommunications, roads, ports, railways etc. to reach the international standard alone, perhaps, will enable India to experience a significant turn-around in export growth. This is essential to improve India's trade balance, current account balance and balance of payments.

15.12 KEY WORDS

O.G.L. List : Items in the Open General Licence (OGL) list can be imported without a licence and without quantitative restrictions, but with the payment of existing customs duties.

c.i.f. : Cost, insurance and frieght are charged in full.

Ad valorem duty : Duties are imposed in proportion to the value of items.

F.o.b. : Free on board. A term given to the system of paying for goods shipped from or to another country when the amount is sufficient to only to cover the value of the goods and excludes insurance and freight.

Annexure I

Export Import (EXIM) Policy 2002-07

The Special Economic Zone (SEZ) scheme has been strengthened by permitting the setting up of offshore Banking Units, hedging of commodity price risks and sourcing of short term External Commercial Borrowings. Supplies by domestic units to SEZs would etitle the former to avail of Duty Entitlement Passbook Scheme benefit. The policy has also ensured procedural simplification in the process of subcontracting carried out by the SEZ units. To ease the power situation in and around the SEZs, units for generation and distribution of power have been permitted to be set up in the SEZs.

The Policy gives a major thrust to agricultural exports by removing restrictions on designated items. The efforts to promote exports of agro and agro-based products in the floriculture and horticulture sector have been sustained with the notification of 32 Agri-Export Zones across the country. Non-actionable subsidies such as transport subsidy have been provided for the export of fruits, vegetables, floriculture, poultry and dairy products. All Quantitative restrictions on exports (except a few sensitive items) have been removed with only a few items being retained for export through State Trading Enterprises. To improve the productivity and export competitiveness of small scale, cottage and handicrafts sector, the Policy provides a package of incentives, including exemption from maintaining the average export obligation under the Export Promotion Capital Goods (EPCG) scheme, permission to achieve a lower threshold level for achieving the Export House status, preferential access to Market Access Initiative funds and duty free access to trimming and embellishment for achieving value added exports. The towns of export excellence (such as Tirupur for hosiery, Panipat for woolen blanket and Ludhiana for woolen knitwear) are intended to be regional rural motors of economic development for the small scale sector, focusing on plugging critical infranstructural bottlenecks and enhancing quality of support services for industrial development.

To provide the necessary impetus to star achievers, EXIM Policy provides a strategic package for status holders comprising of new/special facilities like issuance of Licence on self-declaration basis, fixation of input-output norms on priority, exemption from compulsory negotiation of documents through banks, cent percent retention of foreign exchange in Exchange Earners' Foreign Currency account, enhancement in normal repatriation period from 180 days to 360 days and not mandating exports in each of the three licensing years for achieving the status. The Policy has operationalised the procedure for duty free import of fuel under the Advance Licensing Scheme, provided the license holder has a captive power plant.

In view of phasing out of all restrictions on textile products by 2005 under the Agreement on Textile and Clothing (ATC), the EXIM Policy has focused on measures to encourage value added exports in the garment sector. Electronic Hardware Technology Park (EHTP) scheme has been modified to enable hardware sector to face the zero duty regime under Information Technology Agreement (ITA-1), mandating only a positive net foreign exchange as a percentage of exports criteria and obviating any other export obligation for units in Electronic Hardware Technology Parks. The changes carried out in the gems & jewellery scheme include abolition of the licensing regime for the import of rough diamonds, reduction in the value addition norms for export of jewellery and permitting personal carriage of jewellery.

The medium term Policy continues with all the duty exemption/remission schemes, along with existing dispensation of not having any value caps. Procedural simplifications introduced in the policy include abolition of DEEC Book and withdrawal of Annual Advance License under the Advance License scheme, dispensation with technical characteristics for audit purposes under the Duty Free Replenishment Certificate scheme, 12 years export obligation period with 5 years moratorium for Export Promotion Capital Goods licenses of Rs. 100 crore or more and supplies under deemed exports to be eligible for export obligation fulfillment along with deemed export benefits.

Procedural simplifications have been made in the EXIM policy to further reduce transaction costs covering Directorate General of Foreign Trade, customs and banks. These include adoption of 8 digit commodity classification for imports which would eliminate the classification disputes, reduction of maximum fee limit for electronic filing from Rs. 1.5 lakhs to Rs. 1 lakh, introduction of same day licensing, new norms for reduction in percentage of physical examination of export cargo, introduction of the simplified brand rate of drawback scheme and permitting direct negotiation of export documents. Other salient features of the EXIM Policy 2002-07 include widening of the scope of the Market Access Initiative scheme to include activities considered necessary fora focused market promotion of exports, setting up of "Business Centre" in India missions abroad for visiting Indian exporters/businessmen for ensuring a facilitatory environment for exporters, tansport subsidy for exports to units located in North East, Sikkim and J&K and introduction of Focus Africa with Focus CIS to follow, to diversify markets.

Annexure II

Task Force or Indirect Taxation: Proposed Roadmap for Trade Reforms

The Finance Ministry Task Force (Kelkar Committee) or indirect taxes has suggested a roadmap for further reforms in, inter alia, areas like customs tariff and exemptions, customs procedures and trade facilitation, export promotion and improving automation and tax administration. On **Customs Tariff and Exemptions,** the Task Force has recommended, besides a zero duty for essential items, 10 percent duty for raw material, inputs and intermediate goods and 20 percent for final goods by 2004-05. Following introduction of State VAT, these duties are proposed to be reduced further to 5 percent (for basic raw materials), 8 percent (for intermediate goods), 10 percent (for finished goods) and 20 percent (for consumer durables) by 2006-07. The Task Force has refrained from suggesting any proposed rates for agricultural products since these products stand on a different footing. Suggesting reduction in multiplicity of levies, it advocates retention of only three types of duties (viz. Basic Customs Duty, Additional Duty of Customs and Anti-dumping/Safeguard duties) with all other duties being removed, with the removal of SAD being linked to implementation of State level VAT. Removal of all exemptions except in case of life saving goods, goods of security and strategic interest, goods for relief and charitable purposes and international obligations, has been recommended as a policy, with upfront budgetary provisions in other cases where relief is justified. End-use based conditional exemption should be avoided and if unavoidable, the confirmation of end-use should be done on the basis of selective post clearance checks by using risk assessment techniques. As a ageneral policy, there should be no exemption from countervailing duty and further there should be a move away from specific rates towards at valorem rates.

The Task Force has recommended systemic changes in **Customs Procedures and Trade Facilitation,** based onmodern best-practice which relies on self-compliance, risk analysis and management and is supported by periodic post audits of records. The recommendations in this direction include a universal green channel, expansion of EDI network to all ports and all processes, replacement of verification of self assessment of bill of entry by the importer, permission to file period bill of entry and permission to release imported goods at minimum documentation for importers with good track of compliance.Other recommendations for improved customs administration include availability of customs officers on holidays, especially at international airports, so that exports are not held up, framing of export valuation rules, permission for payment of customs duty through cheques, provision for acceptance of Export Obligatioin Discharge Certificate without delay, expansion of scope of confiscation provisions in respect of export goods to include non-dutiable goods as well as goods not covered under drawback scheme and suitable amendment to the Trade and Merchandise marks Act and the Copyrights Act to empower the Customs officers to enforce IPR. To ensure better service and accountability, suggestions have also been made to streamline the licensing and functioning of Custom House Agents.

Recommending doing away with multiplicity of **Export Promotion Schemes,** the Task Force has identified a viable export strategy to focus on Special Economic Zones (SEZ) and Export Oriented Unit (EOU) schemes for grant of duty exemption on all goods required for export production, Advance Licensing scheme to grant duty exemption to actual users oncapita goods, raw material etc., subject to post clearance intelligence and audit based verifications, and Drawback scheme to provide the mechanism of refund of duties. Access to Domestic Tariff Area (DTA) for EOU/EPZ units using wholly indigenous raw materials is proposed to continue at 50 percent on payment of central excise duty, and for other EOU/EPZ units, 100 percent DTA access to be allowed subject to payment of full customs duty on like goods, as if imported.

Improvements suggested in the drawback scheme include expansion in the scope of the scheme to provide for rebate of all duties and on all goods going into export production, modification in software to ensure amount of drawbacks blocked does not exceed the amount of drawback under dispute, acceptance by the customs of bank realization certificates as proof of realization and payment of penal interest by the Department on delayed drawbacks beyond one week. Duty Exemption Pass Book scheme should be merged with the Drawback scheme from April 1, 2005. Suggestions to facilitate better coordination between the Directorate General of Foreign Trade (DGFT) and the Customs include simultaneous notification of duty exemptions along with the policy announcement, use of EDI technology by DGFT and customs for exchange of information and setting up of an appropriate institutional arrangement to resolve the co-ordination problems between the two. Another important recommendation of the Task force relates to suitable strengthening of independent body such as the Tariff Commission to carry out investigations relating to injury determination, dumping margin, etc. relating to Safeguard duties and Anti-dumping duties.

The report on direct taxes has recommended continuation of the phase out programme for withdrawal of export related incentives under sections 80HHB, 80HHBA, 80HHC, 80HHE, 80-O, 80R, 80RR and 80RRA. It has also recommends elimination of tax exemption u/s 10A and10B of the Income Tax Act for all tax payers other than those engaged in manufacturing computer software.

The proposed reforms in indirect taxes are expected to reduce the transaction costs of Indian exports by around 50 percent, the potential gains to the economy being around Rs. 4000-5000 crores per annum. Such reduction in transaction costs is important not only for boosting exports and foreign direct investment but even for creating an appropriate framework for vibrant domestic business.

UNIT 17 GLOBALISATION OF THE ECONOMY—IBRD, IMF AND WTO

Structure

17.0 OBJECTIVES

This unit explains the meaning of the Globalisation of the World economy and the institutions that have come into existence as part of the process of the globalisation. After going through the Unit you should be able to :

— trace the historical process of globalisation

— describe the functions and structure of the institutions that govern the global economy

— critically assess the impact of globalisation

17.1 INTRODUTION

The word globalisation has now become familiar to most of us. The idea suggests that the world is undergoing an increasing process of international interdependence so that national economies as distinct entities with supreme authority within their territorial jurisdiction are becoming increasingly irrelevant. This does not mean the creation of a world or global community based on equality. Historically, the international economic system has developed on the basis of nation-states. Revolution in transport and communication, highly sophisticated industrial production technologies in the post-war period created a capitalist world market. The Bretton Woods System created in the post-war period that laid down the rules for international trade and commerce, collapsed in the seventies. The nineties has seen the emergence of the process of globalisation. New institutions and rules to govern world trade have come into existence in the form of WTO – World Trade Organization.

17.2 GLOBALISATION — ITS MEANING AND STRUCTURES

We must recognise the conceptual distinction between the international economy and globalized economy. 'International' economy refers to the collective is one in which process and outcome of the various national economies at the international plane. "International economy is an aggregate of nationally located functions". A wide range of international economic interactions such as financial markets and trade in manufactured goods tend to function as opportunities or constraints for nationally determined economic actions. In a global economy, as markets and production become global and interdependent, domestic policies whether of private corporations or sovereign states, have to take into account the predominantly supra - national determinants of their spheres of operation. The state has to construct national policies to cope with increasing inter-connectedness of production, markets, at the global plane. As factors of production becomes international, particularly finance, and market forces extend to the global plane, the role of the sovereign state becomes subordinate to the dictates of global markets. Another major consequence of the notion of globalization is the transformation of Multi-National Corporations – MNCs, into Transnational corporations – TNC's, as the major players in the world economy. TNC's capital has no specific national identification and with an internationalised management, it is willing to locate and relocate anywhere in the globe to obtain either the most secure or the highest returns. With the revolution in communications, capital, particularly the financial sector, a TNC could relocate itself at the touch of a button. In a truly globalized economy this would be wholly dictated by market forces, without reference to national monetary policies. A TNC can produce and market at the global level as strategy and opportunities dictated. A TNC's production-base is not restricted within one predominant national location (as with the multinational corporation), but it services global markets through global operations. Thus the TNC, unlike the MNC, is not controlled or even constrained by the policies of particular national states. This process tends to undermine the traditional notion of state - sovereignty.

17.2.1 Historical Background

The post-second world war period of international trade was governed by, what has come to be known as the Bretton Woods System. The great depression of the 30s and the collapse of the international monetary system were attributed to economic nationalism, competitive exchange rate, devaluations, formation of competing monetary blocs and absence of international cooperation. In July 1994, as the Allied forces were moving across France, representatives of forty four nations met at Bretton Woods, New Hampshire, to create a new international monetary order. A consensus emerged, which underscored that, the previous monetary systems which had relied primarily on market forces had proved inadequate. Henceforth, governments acting together would have assumed the responsibility of managing the international monetary system. United States of America, as the dominant economic and military power in this phase, assumed the primary responsibility for establishing a post - war economic order that was designed to prevent economic nationalism and encouraging free trade, along with increased international interaction. A liberal economic system, with international cooperation, was assumed to promote lasting peace. The United States and the United Kingdom, drew up a plan for new system of international monetary management. The Anglo-American plan, approved at Bretton Woods, became the first collective international monetary order that provided a basis for growing international trade, economic growth and political harmony among the developed market economies. Twenty seven years later, on August 15, 1971, President Nixon appeared on television to announce to the world the end of the Bretton Woods System, and that, the US would no longer abide by the rules and procedures of the International Monetary Order. The successive oil crises, the growing instability in the market economies, fall in the growth rates of the industrialised countries, have contributed to the increasing trend towards, what is now termed, 'globalisation' in the nineties. Before we go on to explain 'globalisation' let us turn back to the Bretton Woods system and the institutions established under it, particularly the International Monetary Fund

(IMF) and International Bank for Reconstruction and Development (IBRD) known as the World Bank.

17.2.2 Bretton Woods System

Under the system, it was agreed that fixed exchange rates was the most conducive to trade and economic stability. Thus all countries agreed to establish the parity of their currencies in terms of gold and to maintain exchange rates within one per cent, plus or minus, of parity. The rules further sought to encourage an open system by committing members to the convertibility of their respective currencies into other currencies and to free trade. The IMF was to be the enforcing authority of the rules and the main instrument of public international management.

To facilitate post-war recovery, the IBRD or World Bank was created with a capitalization of $ 10 billion and was expected to make loans of its own funds and to issue securities to raise new funds. However, the economic destruction of Europe was far too heavy and it was clear by 1947 that only the US contribution of $570 million were actually available for IBRD lending and the credit facilities of the IMF were clearly insufficient to deal with Europe's huge deficits. In 1947 the United States stepped into fill the economic gap left by Bretton Woods and in the next two years a new international monetary system – the dollar standard – (replacing gold standard) based on unilateral American Management Development from 1947 to 1958. The US deliberately encouraged the outflow of dollars (as it had huge balance-of-trade surpluses) through various American Aid Programmes – the Marshall plan for European recovery, the Truman plan for aid to Greece and Turkey etc. Another source of dollar liquidity for the international monetary system grew out of the Cold War, i.e. the American aid to its military allies and US troop deployment across the world. The Cold War required significant military expenditures, overwhelming by the United States. Thus the dollar became the world's currency and the United States became the world's central banker, issuing dollars for the international monetary system.

The Bretton Woods Conference established the –

1) International Monetary Fund (IMF) to alleviate the problems of international liquidity, i.e. to help the member countries to meet their balance of payment deficit and international monetary instability.

2) The International Bank for Reconstruction and Development (IBRD) to help the reconstruction and development of various national economies by providing long - term capital assistance; and

3) The International Trade Organization (ITO) to work towards the liberalization of trade.

The IMF and IBRD, known as the Bretton Wood Twins were established in 1946. The proposed ITO did not materialize. In its place came the General Agreement on Tariffs and Trade (GATT). The World Trade Organization (WTO) of 1995 was the culmination of prolonged GATT negotiations in the earlier era within the framework of the GATT.

17.2.3 IMF : Objectives and Functions

The IMF is an organization that seeks to promote international monetary cooperation and to facilitate the expansion of trade, and thus to contribute increased employment and improved economic conditions. Its membership consists of 153 countries which today account for over 80% of world trade. Membership of the IMF is a prerequisite to membership in the World Bank. There exists a close relationships between the two organizations as well as between the IMF and GATT. The IMF is a specialized agency within the United Nations system.

The important functions of the IMF are –

1) To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income.

2) To promote exchange – stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

3) To eliminate foreign exchange restrictions which hamper the growth of world trade. The fund also provides loans to members to correct maladjustments in their balance of payments, without resorting to measures detrimental to national or international prosperity. The IMF thus combines three major functions : Regulatory, Financial and Consultative.

The Fund maintains a large pool of financial resources that it makes available to members temporarily and subject to conditions to enable them to carry out programmes to remedy their payment deficits. The policy adjustments that countries make in connection with the use of the Fund resources is geared to improve support credit-worthiness with other official sources and private financial markets. The Fund also helps members to coordinate their national economic policies internationally as the focus of the fund is not only on the problems of individual countries but also on the structure of the international monetary system. Sometimes, such problems at the two levels of concern for the IMF are in conflict with one another, which tends to be to this disadvantage of the weaker national economics of the world.

17.2.4 Structure

The work of the IMF is carried by the Board of Governors, an Executive Board, a Managing Director and the staff. Each member country is represented by a Governor on the Board of Governors, which is the Fund's highest authority, and which meets annually. A member country's voting power is related to its contribution to the Fund's financial resources, which in turn is related to its relative size in the world economy. The Board of Governors delegates most of its powers to the Executive Board, which is responsible for conducting its business. The Executive Board is chaired by the Managing Director.

Resources – The resources of IMF come from subscription by members and borrowings. Every member is required to subscribe to the Fund an amount equivalent to its quota. Each member is assigned a quota expressed in Special Drawing Rights (SDRs). Quotas are used to determine the voting power of members, their contribution to the Fund's resources, their power to determine these resources and their share in the allocation of SDRs. A member's quota reflects its economic size in relation to the total membership of the Fund. The IMF is also authorized to supplement its resources by borrowing to forestall any threat to the strength of the international monetary system. The eleven highly developed industrial countries of the world have undertaken to lend to the IMF, if necessary.

The states can borrow from the IMF to meet their balance of payments needs, under various policies and facilities. Those who borrow from the Fund are required to follow an economic policy programme aimed at achieving a viable balance of payments position over an appropriate period of time. This is known as conditionality and reflects the principle that financing and adjustment must go hand in hand. IMF conditionality and its adjustment programmes (Structural Adjustment or SAP) are the subject of much debate in the developing countries. These conditionalities and structural adjustment programmes/policies that have been imposed on the developing countries include withdrawal of subsidies, devaluation of currencies, privatisation of economy etc. that have resulted in unemployment and have directly affected adversely the poorer sections of the socie[illegible] current debate in India on the economic policies of liberalization and withdrawal of [illegible]es reflects the controversial policies of the IMF.

17.2.5 International Bank for Reconstruction and Development

The International Bank for Reconstruction and Development was established in 1945. It has two other affiliated institutions :

The International Finance Corporation (IFC) established in1956: and the International Development Association (IDA) established in 1960. Membership of the IMF is the principal condition for membership of the Bank.

Objectives

The objectives of the Bank as laid down in the Articles of Agreement are –

1. To assist in the reconstruction and development of the member states, by facilitating capital investments for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace-time needs, and the encouraging of the development of productive facilities and resources in less developed countries (LDCs).

2. To promote foreign investment by means of guarantees or participation in loans and other investments made by private investors, and when private capital is not available on reasonable terms, to supplement private investment by providing, or suitable conditions, finance for productive purposes out of its own capital funds, raised by it and its other resources.

3. To promote long-range balanced growth of international trade and the maintenance of equilibrium in the balance of payments, by encouraging international investment of the productive resources of members in order to raise productivity, the standard of living and conditions of labour in the various countries of the world needing such help.

17.2.6 Functions

The IBRD, whose capital is subscribed by its member countries, finances its lending operations primarily from its own borrowings in the world capital markets. The Bank's loans have a grace period of five years and are repayable over twenty years or less. They are directed towards developing countries at a relatively advanced stage of economic and social growth.

The Board of Governors, on which each member country is represented by one Governor exercises all power vested in the Bank. The Governors of the Bank have delegated their powers to a Board of Executive Directors, which perform its duties on a full time basis. There are 21 Executive Directors who are appointed by the five members having the largest number of shares of capital stock and the rest are elected by Governors representing the other member countries.

The Bank assesses the repayment prospects of its loans, and for this purpose, takes into account the availability of natural resources, the country's past debt record etc. The bank lends only for specific projects which are economically and technically sound and of a high priority in the context of its larger objectives. As a matter of general policy, it lends for projects which are designed to contribute directly to economic productivity, and normally does not finance projects of primarily social character, such as education and housing. Most bank loans have been made for provision of basic utilities, such as power and transport which are prerequisites for economic development. The Bank encourages the borrowers to procure machinery and goods for Bank-financed projects in the cheapest possible market consistent with satisfactory performance. Finally, the Bank indirectly encourages promotion of local private enterprise.

In recent years the Bank has stepped up its lending for energy development, which now forms the largest part of the Bank's lending programme. Gas and oil development have also shown increasing attention in Bank lending. As economic conditions deteriorated in the third world countries in the 1980's the bank inauguarted a progrmme of structural adjustment lending. This lending supports programmes of specific policy changes and institutional reforms in less developed countries designed to achieve a more efficient use of resources. In 1983, the bank initiated its special action programme (SAP) for a two-year period designed to increase assistance to countries trying to cope with exceptionally difficult economic environment due to global recession. This comprised financial measures, combined with policy advice, needed to restore credit worthiness and growth.

17.2.7 General Agreement on Tariffs and Trade

An attempt to create an international organization to look after matters of trade and commercial policy were made as early as1947. Although a charter for an International Trade Organization was drafted at the Havana Conference it was never ratified due to differences between those who wanted a free multilateral trading system and those who placed emphasis on full employment policies on a national basis. However, the American proposal for a general agreement on tariffs and trade was agreed upon, and many nations signed. So emerged the General Agreement of Tariffs and Trade with no formal organization and no elaborate secretariat. It is though increasing liberalization of world trade and through GATT negotiations that the world Trade Organization emerged in 1995.

The two outstanding features of GATT were the principle of non discrimination and the principle of reciprocity with the purpose of promoting fair and free international trade among members. To ensure non-discrimination the members of GATT agreed to apply the principle of MFN (Most Favoured Nation) to all import and export duties. This meant that each nation shall be treated as well as the most favoured nation. However GATT did not prohibit economic integration such as the formation of free trade areas or customs unions, provided that the purpose of such integration was to facilitate trade between constitutent territories and not to raise barriers to the trade of other parties.

Several rounds of GATT negotiations aimed at reduction of triffs and non tariff barriers to trade led to the lowering of duties on trade, involving more than two-third of the world's States.

17.2.8 Uruguay Round and World Trade Organisation

The last round of multilateral trade negotiations known as the Uruguay Round (held in Punte del este in Uruguay), which was the eighth round, centered around three main issues –

1) Trade Related Intellectual Property Rights (TRIPS)

2) Trade Related Investment Measures (TRIMS) and

3) Trade in Agricultural Commodities.

The Third World countries have been by and large dissatisfied with GATT negotiations. Liberalisation of trade related intellectual property rights would mean that the less developed countries would have to compete with the advanced countries or the transnational companies. TRIPS covering copyrights, patents and trademarks is likely to harm the indigenous technology and nascent industries – particularly pharmaceutical and drug industry. GATT covers the service sector as well under TRIMS. This is likely to affect the employment conditions in the developing countries as they will be swamped by professionals from the advanced industrial countries. Agriculture is another contentious issue under GATT. While the US insisted on free trade in agriculture, withdrawal of state subsidies, EEC countries particularly France, which heavily subsidize their agriculture objected. The US threatened to use a law called super 301, under which punitive action is taken against countries which do not follow a free trade regime.

17.2.9 World Trade Organisation

The Uruguay Round was scheduled to be completed by 1990, that is within four years after its commencement. However, as the negotiations reached a deadlock over several contentious issues, the Director General of GATT – Arthur Dunkel intervened and proposed a draft that is known as the Dunkel Draft, also decisively called DDT (Dunkel Draft Text). The Dunkel proposals called for reduction in domestic and export subsidies, and replacement of non-tariff barriers, like quotas and quantitative restrictions by tariffs. Then proposals also called for require longer enforcement of copy rights and trade marks in case of India. Such a provision requires a change in India legislation on patents to conform to the Paris Convention.

The multilateral trading system sanctioned by GATT and the Dunkel proposals maintain the predominance of the advanced industrial countries of the West in the international economy. The GATT, the Uruguay Round, and the Dunkel Draft did not take into account the role of MNCs in exploiting the countries of the third world and widening the gap between the rich and the poor in such countries as well as with in the global system.

The Dunkel Draft was signed by member nations of December 15, 1993. After seven years of intensive negotiations, the new GATT agreements of Uruguay Round were ratified in December 1994 by the Indian Cabinet. The significant aspect of the GATT agreement is the establishment of the World Trade Organization (WTO) that supersedes the GATT. The 500 page agreement setting up the WTO ushers in a new era of multilateralisation of world trade. The WTO has become operational since 1st January , 1995 and has a status similar to the World Bank and the IMF. The treaty is binding on all its 117 member countries, two thirds of which are less - developed countries (LDCs). The Organization is expected to be the arbiter between the trading parties and generally ensure that the rules of the game are being followed. A dispute settlement mechanism is also to be established under the WTO. As to how the LDCs (including India with its vast market) fare in the competition with powerful, industrialized countries of the west is yet to be seen.

Check Your Progress 1

Note : i) Use the space below for your answers.
ii) Check your progress with the model answer given at the end of the unit.

1) Define the concept of "International Economy".

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2) What do you mean by globalisation of the economy?

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3) The Brettonwoods System was established in the contract of ....

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4) The IMF is intended ....

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5) GATT was founded to promote .....

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6) What is WTO.

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17.3 POST BRETTONWOODS DEVELOPMENTS

Two significant development in the global economy since 1950 are the growth of regional economic subsystems, and the growth of multinational corporations (MNCs) which operate across national boundaries. While MNCs contribute to globalisation they can also pose a threat to national economic autonomy. Within the core of the capitalist industrialized world, regional economic activity emerged in the of west European Economy leading from a common market to European Union in the 90's; in the Pacific and South East Asia regional subsystems emerged. The emergence of a financial and securities market centred in New York, Tokyo and London is sympton of regionalization and globalization through inter-regional linkage. The growth of MNCs is both the cause and consequence of globalization. The emergence of world markets, and an international economic regime, provided the environment favourable to the growth of transnational firms. Initially such companies were predominantly US-based and sometimes dominated a whole sector of the global economy, imposing standards on it. The classic example is the IBM which at one time accounted for more than 80 per cent of the World Market in computers and was able to use this dominant position to define standards to maintain or increase its share of the market and/or competitive advantage. In the postwar period, the number, range and diversity of MNCs increased along with a changing balance between them in banking, oil, car manufacture and so on. This growth in the MNCs produced more complex interdependence in the global economy. It also posed difficult problems for national economies in areas of investment, capital movement and control of technology. A new managerial class – the class of corporate managers – emerged moving between companies and countries.

The post-war economy clearly indicates three features – the hegemonic position and role of the US in the world economy; the decline of the less developed (or developing) countries share of world exports from 1960-70 ; the relative isolation of the centrally planned economies (or socialist countries) in terms of their share of world trade. These countries (i.e. the socialist economies) did not receive Marshall Aid nor join the Bretton Woods system. Their post-war recovery was followed by world wide recession, with increasing energy prices, as the oil-producing countries of the Gulf hiked oil prices. In 1971, the US suspended fixed dollar convertibility to gold, and world trade and finance moved to a system of flexible exchange rates rather than fixed parities and regulated adjustment mechanisms that had been planned originally. The end of the Bretton Woods system led to the intervention of the

Central Banks of major economies in the money market to keep exchange rate fluctuations within limits and reintroduce some stability into the international system.

Over the last twenty years or so the dominance of the US in the world economy has declined. However, the dollar has retained its role as the principal international currency, and this has helped it to stay at the centre of both monetary and trade regimes. The US still remains committed to the institutions of international economic order and to multilateralism and trade liberalism. But the emergence of Western Europe, particularly West Germany, and Japan as major economic powers has to some extent altered the distribution of economic power in the post-cold war era.

17.3.1 Globalisation and the Third World

The expansion of industrial capitalism to the 'periphery' of the international economy – South Korea, Taiwan, Singapore and the neighbouring newly industrializing countries – 'South East Asian Tiger ' as they are referred to – is also another feature of the 80s . But, these countries are inhabited by less then 2 per cent of the Third World propulation. Throughout the 80s the gap between the rich and poor countries of the world widened and has continues to do so. The hope for a new international economic order (NIEO) through the North-South dialogue have not resulted in any improvement in the conditions of the people of the South. The belief, following neo-classical economies, that unrestricted international trade would allow the poor countries to come closer to the level of the rich, has been belied by historical experience. On the contrary, the lending policies of the World Bank & IMF, the conditionalities and structural adjustment programmes imposed on the countries of the third World – Africa particularly – have resulted in food riots, unemployment and increasing poverty in these countries. It must also be noted that international mechanisms of free trade led to inflation and recession, the deterioration of terms of trade for many European countries.

17.3.2 Impact of Globalisation

The technological advances of the last two decades have brought about a revolution in communications and transportation eroding the boundaries between markets and nation-states. Thus, economic process have become increasingly internationalized in a number of key spheres, like communications, production, trade, finance. New technology has also radically increased the mobility of economic units and the sensitivity of markets, and societies to one another, thus globalising economies of the world. This has paved the way for the ideal of global free trade to be achieved through the World Trade Organization (WTO).

Globalization has brought about radical changes in the production process, shifting industry from its old centres in the rich countries with high labour costs to countries of abundant cheap labour. While, earlier, labour remained a major factor of production, technology continued to render human labour redundant thus increasing unemployment and under-employment. Historically such pressures have been met by state interventions, like protectionism. However, globalisation with a free market ideology removed or weakened the possibilities of state intervention – whether in the form of subsidies or protection of their internal markets. While the labour in the developed countries fear losing jobs, the third world countries hope to see increasing employment opportunities. But, when commitment to free market ideology compels governments of the west, and more particularly the third world countries, to reduce the costs of social security and public welfare, mass reduction of employment and marginalisation of large sections of the society is inevitably taking place. Such social and political consequences of globalisation are likely to be world-wide, with its relatively greater impact with in the countries of the Third World.

An important consequence of globalisation is labour migration. As labour migrates to the industrialized countries of the West, or the oil-producing countries of the Gulf, in search of jobs social conflicts are on the increase. Racism in Germany and other western countries, resentment against immigrants in the Gulf by the local people are examples of this. Revolution in communications has undoubtedly brought the different parts of the World closer. Yet, that in itself is not sufficient to build a global community. An important

consequence of globalisation of economies is also fragmentation of societies, rise of movements of identities – ethnic, nationalist and religious. Free trade and WTO do not automatically harmonize the interest of the states. This is quite evident from the conflicts between the US and European countries over questions of telecommunications and satellite T.V. programmes, electronic industries etc. Economic globalisation should not be equated with the emergence of a Global community as a Nation. States (even after if their sovereignty has been undermined) continue to assert their priorities and interests over global interests. These conflicts tend to produce global insecurity and inter-state tensions.

Check Your progress 2

Note: i) Use the space below for your answers.
ii) Check your progress with the model answer given at the end of the unit.

1) What are the most significant development in the field of international economy during the post Brettonwoods period.

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17.4 LET US SUM UP

Globalisation is a process of intensifying economic inter-connectedness and interdependence of the national economies of the World. This tends to curtail the powers of the state to regulate their economies. Globalisation has been a historical process. The post-war period has seen the establishment of institutions that attempted to regulate the international monetary and trade relations. These institutions are the IMF, the World Bank and the GATT. The system was known as the Bretton-Woods system. However, this system under the hegemony of the United States of America collapsed in the 70s because the United States, unilaterally, refused to abide by its rules and procedures. The subsequent oil crisis followed by the revolution in industrial production through highly sophisticated computerised methods brought about radical changes in the international economic order. The Western countries need for resources, the economic crisis and stagnation in these countries, eventually led to globalisation under American hegemony. The process of globalisation has neither promoted equality among the national-states nor necessarily development for the third world countries. The transnational corporations and the industrialised countries continue to exploit and enjoy a dominant position in the global economy. The World Trade Organisation has been set up following the Uruguay Round of GATT.

17.5 KEY WORDS

Allied forces : The World War II was fought between two power blocs, known as Allied forces and Axis forces. The forces were led by the UK, USA, France and the erstwhile USSR.

Dunkel Draft : In order to break the deadlock in the Uruguay Round negotiations, The Director General of GATT, Mr.Arthur Dunkel prepared certain proposals. They have came to be known as Dankel Draft.

Service Sector : There are two sectors in any Country's economy, namely, primary sector and secondary sector. Primary sector is directly involved in production of goods and services. Secondary sector offers services to the people, it is, therefore, known as service sector.

UNIT 18 RISE AND FALL OF BRETTON WOODS INSTITUTIONS

Structure

18.0 OBJECTIVES

After reading this Unit, you will be able to:

- discuss the genesis and rationale of Bretton Woods Institutions;
- describe their operations and working;
- list the objectives and functions of these institutions;
- assess for yourself how far these institutions have achieved their objectives;
- identify the shortcomings of these institutions; and
- give suggestions regarding ways to make these institutions compatible with on-going process of globalisation.

18.1 INTRODUCTION

In 1944, as the Second World War neared its end, a conference was convened by the victorious countries in Bretton Woods, in the United States. It was here that the World Bank and the International Monetary Fund were born – in the hope that they would provide the foundation of a peaceful and prosperous future for the world.

Sixty years later, these two multi-lateral institutions also known as Bretton Woods Institutions (BWIs) occupy a dominant position in the global political economy, but they are the target of powerful attack – both in the streets and in media. And in course of those 60 years, they have been joined by a whole range of other multilateral institutions. In the Course of this period, a great deal had changed. The anniversary of the World Bank and IMF was met with a 'Fifty Years in enough' campaign. While some people see those institutions, and the multilateralism they promote, as important role in the elimination of world poverty others see them not as a solution, but recent years, been greatly increased public attention and criticism of the multi-lateral institutions.

18.2 WORLD BANK

The World Bank group is a partner in opening markets and strengthening economies. Its goal is to improve the quality of life and expand prosperity for people every where, especially the world's poorest.

The World Bank group of institutions includes as follows:

1) **The International Bank for Reconstruction and Development (IBRD)** founded in 1944 in the single developing countries and a major catalyst of similar financing from other sources.

2) **The International Development Association (IDA)** founded in 1960, assists the poorest countries by providing interest free credits with 35 to 40 years maturities.

3) **The International Finance Corporation** supports private enterprise in the developing countries by providing interest free credits with 35 to 40 years maturities.

4) **The Multilateral Investment Guarantee Agency (MIGA)** offers investors insurance against non-commercial risk and helps developing country governments to attract foreign investment.

5) **The International Centre for the Settlement of International Disputes (ICSID)** encourages the flow of foreign investment to developing countries through arbitration and conciliation facilities.

Over the years, the World Bank has made two significant departures in its policy of lending; it changes its policy of lending to government and public sector and concentrated on private sector, and it changed its approach from a project based lending to sector-based lending.

18.2.1 Lending Operations of World Bank

Resources of the Bank consist of the capital and borrowings. The capital of the bank is contributed by its 184 member-countries. Besides, the Bank raided capital by sale of bonds on the World's capital markets where the Bank is the World's largest non-government borrower in the international market.

The Bank leads only to under-developed countries, and even among them it "graduated" its borrowers when per capita income reaches a threshold. The Bank marked or facilitated loans in one or more of the following ways:

- By making or participating in direct loans out of its own funds; or
- Out of funds raided in the market; or

- By guaranteeing the whole or part loans made by private investors through the investment channels.

In recent years, the Bank also moved into "co-financing", with governments and private banks and co-financiers with projects. However, since the mid-1980s when the debt crisis occurred, co-financing has become less popular with commercial banks, but governments have made much use of the Bank's expertise by putting a part of their foreign aid into the projects.

Before granting or guaranteeing a loan the Bank considers the following matters:

i) The project for which the loan is asked has been carefully examined by a competent committee as regard the merit of the proposals.

ii) The borrower has reasonable prospects for repayment;

iii) The loan is meant for productive purposes; and

iv) Except in special circumstances, the loan is meant to finance foreign exchange requirement of specific projects or reconstruction and development.

The amount of the loan granted by the Bank should not exceed 100% of its total subscribed capital and surplus. Rate of interest is determined by adding a spread of '1/2 of %' over the 'pool rate' of outstanding borrowing of the Bank. In lending for development projects in developing countries, the Bank estimates a likely rate of return; this must be above a minimum 10 per cent for the project to go forward.

18.3 INTERNATIONAL MONETARY FUND (IMF)

The important objectives before the Fund presently are as follows:

- To promote international cooperation;
- To facilitate the expansion and balanced growth of international trade;
- To addict in establishing a multilateral systems of payments for current transactions between member countries as well as in eliminating foreign exchange restrictions that hamper the growth of world;
- To make available to the member countries the IMFs general resources on a temporary basis to enable them to correct BOP difficulties without resorting to measures that would harm national or international prosperity;
- To shorten the duration and lessen the degree of disequilibrium in the BOP of member countries.

The basic functions of the IMF are as follows:

i) To lay down ground rules for conduct of international finance;

ii) To provide short and medium-term assistance for overcoming short-term BOP deficits; and

iii) Creation and distribution of reserved in the form of special Drawing Rights (SDRs).

The Fund has 184 member-countries accounting for more than 80 per cent of the total world population and 90 per cent o the world trade. Each member-country contributes a certain sum of money called a quota subscription as a cost of membership fee.

Quota represents the subscription by a member-country to the capital fund of the IMF. Quotas are fixed for each country taking into account such factors as (i) GNP

of the country, (ii) current account transactions, (iii) variability of current receipts, and (iv) official reserves.

Each member country contributes 25 % of its quota in the form of SDR or foreign exchange and 75% in the country's own currency. Quoted serve various purposes:

- They determine the member's contribution to the Fund's resources which form a pool of money that the IMF can draw to lend to members in financial difficulty.
- The determine the voting powers of the members (each country has 250 basic votes plus one additional vote for each SDR 1,00,000 of quota).
- They are the basis for determining how much the contributing member can borrow from the IMF.
- They are the basis for determining how much each member receives form the IMF in periodic allocation of SDRs.

Overall, each member's quota is the most fundamental element in its financial relationship with the IMF.

IMF provides temporary assistance to member countries to tide over BOP deficits. When a country requires foreign exchange, its tenders its own currency to the IMF and gets the foreign exchange. This is known as drawing from the Fund. When the BOI condition of the country improved, it should repurchase its currency from the Fund and repay the foreign exchange.

Ordinarily, for a member-country, a first borrowing or drawing is virtually automatic and within string. A country simply called for the return of its original 25 per cent share (called the 'reserve tranche', tranche being French for 'slice') paid in hard currency. After that it may borrow four more credit tranches (each 25 % of its quota) in each of the subsequent four years. Thus, a member can borrow, almost automatically, upto 125% of its quota in a period of five years. Beyond this, if the IMF approves a member's plan for economic reforms, the member can borrow a further 90 per cent of its quota annually for three years under the 'enlarged access' policy. This limit can be raised to 100 per cent of the quota. All told, a member country can seek foreign exchange upto a cumulative upper limit of 400 to 440 per cent of its quota.

The purchase of the first or the reserve tranche is tree of any strings or conditions. But obtaining the second, third and fourth credit tranches and money from the extended access policy involves an ever grater degree of IMF supervisions, including substantial consultation with the officials of the Fund and a visit by the IMF financial teams. Typically, the IMF will require as prerequisites for borrowing cutback in budget deficit including subsidies to various sectors of the economy, reduction in the rate of monetary expansion, measures to restrain wages and prices, devaluation of an overvalued exchange rate, and some action to make the price system reflect costs more accurately and some steps to encourage exports. These are known as 'conditionalties' attached to assistance from the IMF. The conditionalties have proved to be the most controversial aspect of IMF operation in recent years. The major complaints of the borrowers against the IMF conditionalities are that it has become tougher, with stiffer norms towards borrower's domestic policies and that low income groups within a country bear the burnt of the adjustment.

18.3.1 Special Drawing Rights (SDRs)

SDRs are entitlement granted to member countries enabling them to draw from the IMF apart from their quota. It is similar to a bank granting a credit limit to the

customer. When SDRs are allocated, the country's Special Drawing Account with the IMF is credited with the amount of the allotment.

SDR is not a currency. It is merely an asset created out of book entries. As such it is an independent reserve asset. The volume of SDRs can be increased or decreased according to the reserve needs of the international liquidity. Initially, the value of one SDR was equal to a specific quantity of gold (which equalled the value of 1 US Dollar) and provided with an absolute gold value guarantee. That is why SDRs were popularly known as 'Paper Gold'. Later, the value of SDR was linked to a basket of five currencies. The basket is reviewed every five years. It currently, consists of the Euro, the Yen, the Pound sterling and the US Dollor. When a member country utilises SDRs in holding would be less than the allocation. SDRs can be used directly among the members. A country may swap SDRs with another country to acquire a currency it desires. SDRs may be utilised to pay charges to IMF. SDR may be utilised to pay charges to IMF. SDR has gained importance both as a reserve asset and as a Unit of settlement of international transactions. Some international banks time deposits designated in SDR. Some countries have pegged their currencies to SDR.

18.3.2 IMF-World Bank Harmony

Bretton Woods institutions work in tandem. World Bank BOP support is not available with a Fund Programme, while a Fund Programme cannot be finalised without the prior negotiation of BOP support from the World Bank and from bilateral donors to fill the programmed resources gap. The bilateral donors do not commit funds until negotiations with the World Bank have been concluded. Whereas the IMF sets the macro-economic guidelines and targets of a programme, the World Bank imposed a list of neo-liberal macro-economic policy reforms on the borrowing country.

How Does the IMF Differ From The World Bank?

Table 18.1 below summarises the basic differences among the two institutions.

Table 18.1: Distinct Roles of the IMF and the World Bank

International Monetary Fund	World Bank
Oversee the international monetary systems and promotes international monetary cooperation.	Seeks to promote economic development and structural reforms in developing countries.
Promote exchange stability and orderly exchange relations among its members.	Assists developing countries by providing long-term financing of development projects and programmes.
Assists members in temporary BOP difficulties by providing them with the opportunity to correct maladjustments in their BOP.	Provides special finance assistance to the poorest developing countries through the IDA.
Supplements the reserves of its members by allocating SDBs if there is a long-term global need.	Stimulates private enterprise in developing countries through its affiliate, the International Finance Corporation.
Draw its financial resources principally from the quota subscriptions of its members.	Acquires most of its financial resources by borrowing on the international bond market.

18.4 ACHIEVEMENTS OF BRETTON WOODS INSTITTUTIONS

Some of the important *achievements* of the BW Institutions can be summarised as follows:

1) International reserves have increased substantially, providing a larger borrowers, halt now hold reserves greater than 150 per cent of maturing short and long-term debt; less than one-sixth had such coverage healing into 1997.

2) There have been improvements in fiscal performance, with some notable cases of governments achieving and sustaining large primary surpluses.

3) External balances have improved, with current accounts in most of the emerging world in surplus or modest deficit. Only 2 of the 20 largest borrowers now are running deficits in excess of 3 per cent.

4) Exchange rate regained are ore resilient and less fragile, and a substantial majority of the largest borrowing countries have moved to flexible, regimes, and away from the fixed-but adjustable pegs that proved so dangerous in the crises of the 1990s.

5) Important progress has been made in building credibility for new monetary policy requires, and inflation is generally moderate.

6) Governments have made major investments in recapitalising and restructuring their troubled financial systems. For example, in Asia, where some of the most severe problems were encountered, governments have spent over $500 billion carving out problem loans and bolstering capital.

7) Growth rates have improved with the restoration of domestic stability and recovery in external demand. Indeed, aggregate growth currently is runni9gn at its highest rate since the on set of the crisis in 1997.

8) With these improvements, and generally accommodative external financial conditions, borrowing costs have fallen, capital market access was restored for many countries, and credit growth resumed. Net credit growth to sovereigns has remained moderate, however, as much of the borrowing has gone to refinancing the existing stock of debt on more favourable terms.

9) The market for emerging market debt has also matured. There has been more differentiation in the response of spreads, both on the way down and credit fundamentals seemed to improve, and during the recent correction.

This progress is indicative of a general increase in the sophistication and skill of economic policy makers in the emerging world, and in the quality of understanding of the benefits of macroeconomic stability and how to achieve it. Many countries benefited from the advice and financial support from the IMF and the World Bank. But the most successful were those with policy makers who were ahead of the Fund and the Bank in diagnosing and addressing their problems, rather than being dragged reluctantly toward a more credible policy stance.

These improvements have left the emerging markets as a group less vulnerable to financial crisis than they were in the id 1990s. The combination of deeper reserve cushions, stronger external positions, improved balance sheets, more flexible exchange rate required, and better inflation performance provide a very different setting from

what existed the last time the world faced a transition after a sustained period of benign financial conditions and low interest rates.

18.5 FAILURES OF THE BRETTON WOODS INSTITUTIONS

The aggregate improvements catalogued above mark substantial difference across countries and a number of areas of lingering vulnerability. Some of these are as follows:

1) some of the most daunting challenges are in the fiscal and public debt area, where a number of emerging market economies across different regions face very high, and in some cases still growing public sector debt levels. Average public debt burdens in the emerging world have risen to about 70 per cent of GDP, and among countries rated single B and below, the mean rises above 80 per cent.

2) The challenge of managing debt burden of this size is magnified by the fact that the debt structures in a number of countries are still quite vulnerable to foreign currency, liquidity and interest rate risk. The substantial share of public debt denominated in foreign currency – 70 per cent on average for the lowest rated group of borrowers – and the relatively short maturity of the debt stock mean that a relatively modest shock can produce a substantial increase in debt burdens, raising the amount of fiscal effort needed to keep the debt stock on a stable or declining path, and increasing the economy's vulnerability to a crisis.

3) In some countries, the fiscal trajectory is too weak to place the debt-to-GDP ratio in a sustainable path. In others, the fiscal position is strong enough to stabilise the debt dynamism but provided little buffer against adverse shocks, and very little room for fiscal policy to help cushion the effects of such a shock.

4) Important challenges remain in the financial area as well. In many countries, large public sector debt burdens have left banking systems highly exposed to the sovereign, constraining authorised room for manoeuvre. There are also problems in bank's corporate and consumer loans books, and a number of banking systems have also a large share of foreign currency denominated liabilities, in some cases held by non-residents.

5) The durability of recent improvements in external positions, which reflect weak domestic demand in many countries, is also open to question. As domestic demand strengths, external balances could move to deficit again, which in some cases will reintroduce a greater external risk.

6) And in many cases, the financial exposure of the IMF and World Bank is already high.

These balance sheet challenges took a long time to develop, and they will take a long time to reverse. They are the legacy of years of past fiscal decisions, magnified by the impact of crises on growth, the exchange rate, and the financial sector. They leave an exacting set of policy challenges. They raise the risk that future stocks to domestic confidence or adverse changes in the external environment could lead to new pressures on exchange rates, or interest rates, and on the capacity of countries to fund themselves on sustainable terms. Apart form the risk of crisis, these debt levels are large enough to depress domestic investment and long-term growth

prospects. In past because of these balance sheet and debt burdens, many emerging market economies face a protracted transition before they can expect to be comfortably considered stable investment grade credits, with sufficient levels of self-insurance against external and domestic challenges to financial stability. One of the mot pressing challenges for the Bretton Woods institutions is to help assist in this process of reducing vulnerability, by promoting an unwinding of these large balance sheet risks and at the same time, providing a credible form of contingent insurance for those hopefully rare circumstances when their members face extraordinary financing needs.

Check Your Progress 1

1) Explain how World Bank and IMF are different form each other and how they work in close coordination?

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2) State the major achievements of the Bretton Woods Institutions.

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3) Write a note on the failures of the Bretton Woods Institutions

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18.6 RATIONALE IN ERA OF GLOBALISATION AND SUGGESTIONS

In the present era of globalisation where countries have unprecedented access to international capital flows and where those who have borrowed from the Bretton Woods Institutions are doing everything they can to repay their loans, it has been suggested that the Bretton Woods Institutions should closed down, and hence the slogan “sixty is enough”. But it would be too radical a suggestions. For the reasons to be detailed below, not only there is a need for further strengthening of these institutions, there is also a new to restructure them.

18.6.1 Rationale

The rationale for the existence of the Bretton Woods institutions can be grouped in three categories as follows:

A) **Dealing with Global Externalities**

i) Global financial stability and episodes of systemic risk. National monetary authorities may address some but not all of these cases. In a world of greater financial integration, less capital controls, more capital mobility, not money and fickle investors, crises in past triggered by sudden reversal of capital flows cannot be ruled out.

ii) "Irrational" international investors' may derive from payoff externalities (leading to runs), information asymmetries and informational cascades leading to herding behaviour.

iii) Contagion from crisis country to other emerging markets and to advanced economies.

iv) Warning against externalities from poor economic policies and possible need for policy coordination.

v) External effects of liquidity runs and insolvency crises that lead to high liquidation costs.

vi) Need for international financial supervision.

vii) Need for mechanisms for orderly debt workouts.

viii) Need to avoid competitive devaluations wars (that may be proxies for trade policy wars) and severe currency (financial crisis that are highly disruptive of global trade.

ix) Ensure success of globalisation in all its forms (fee trade in goods and services FDI and transfer of information and technologies across countries, increased stable capital mobility and integration, appropriate management of labour migration).

B) **Market failures (even when they do not have international external effects)**

i) Self-fulfilling bank runs, government debt runs, currency crises.

ii) Liquidation costs of liquidity or semi-liquidity crises that results in runs.

iii) Excessive liquidation costs (i.e., the avoidable liquidation costs on top of the unavoidable ones) in insolvency crises where there are also runs.

iv) "Conditionality lending" as a way to resolve two coordination issues: need to design appropriate policy changes based on independent and superior information (thousands of creditors cannot do it) cost – when no private creditor is large enough and risk-neutral enough in a crisis to do that (as uncoordinated creditors rush to the exist) conditionality lending is a form on "delegated monitoring and coordination mechanisms" when there are "multiple principles" for the debtor agent.

v) Reducing the adjustment costs (need for how adjustment and stock adjustment and costly macro/structural reforms) for countries with serious underperformance and policy shortcomings.

vi) Need to actively coordinate debtor and creditors action in crisis management (resolution because of collective action problems (rush to exists, such to courthouse, holdout / tree rider problems) between creditors and between the debtors and its creditors including IMF pushing for appropriate policy regime changes.

vii) Possible provision of lender of last resort support to domestic banking systems that are informally or formally 'dollarised'. As more countries 'dollarise', 'euroise',join monetary and currency unions or are informally dollarised, domestic monetary authorities cannot provide such bender or last resort support.

C) **Domestic Policy Failures**

i) There is too much emphasis on "ownership" ownership of bad policies can lead to disasters. So, at times, the Fund and the Bank will need to be "paternalistic" and tell a country that the policies are unsustainable, that its debt is unsustainable and that its exchange rate regime is unsustainable. Subject to the caveat that some basic ownership is necessary to ensure that an IMF Programme is actually implemented, the IMF should not shy away from being paternalistic when necessary.

ii) But the Fund and the Bank should be careful about who are the "reformers" and who are the "vested interests". In countries with very unequal wealth and income distributions, the oligarchic elites may pursue their own private and corrupt interests.

iii) Going against vested interest and supporting reformers may mean to choose socially progressive reformers. Those advocating reforms that might address some inequality and poverty at times are not defined as "reformers" event though they are taking on vested interest. Vested interests that secure their interests in other ways often have not gotten the some security from the institutions.

Given these different externalities and market failures. The Bretton woods institutions have many important roles as follows:

- Ensure international monetary and macro stability that is essential for economic growth.
- Ensure global financial stability.
- Provide bilateral and multi-lateral surveillance and tools for crisis prevention.
- Provide lending to countries in financial difficulty or crisis.
- Support macro stability, and thus long run growth, in lower income countries.

18.6.2 Suggestions

For the last 60 years the Bretton Woods institutions have played an essential role in ensuring global financial stability and fostering economic growth and development. Further, as would be clear from the above discussion, these institutions are equally important even now. What is required is a strategic review of their functions and roles to identify the areas where these institutions can be constructively reformed to ensure that they maintain the crucial and essential roles that they have played until now. To this end, following suggestions in brief, have been made.

1) **Facilitating Restructurings**

There has been some progress in the last few years in efforts to improve the framework for sovereign restructurings. In particular, collective action clauses have become the market standard where emerging market governments issue debt under foreign law. The Bretton Woods institutions should be willing to lend to a sovereign that is in default to its private creditors only when two conditions have been established.

One, the country must commit to a credible medium-term adjustment programme, one that offers that prospect of a successful restructuring and a reasonably early return to the capital markets. This has to be established upfront for any restructuring effort to work. Commitment to a credible adjustment path that offers the reasonable prospect of a return to financial visibility and growth is the necessary foundation for engagement by the creditors in a restructuring process. Without that, there is little basis for meaningful engagement.

Two, before an institution can commit its support, the country must develop, in consultation with its advisors, and outline to the institution and its creditors, a credible and monitorable framework for cooperatively achieving a viable debt restructuring, one that leaves the country with a sustainable debt burden. The issues of appropriate adjustment and appropriate broad terms of proposed restructuring are closely intertwined and need to be assessed in tandem. For the BW institution, it should be an essential prerequisite that the country demonstrate at the outset that its approach has credible prospects for enlisting broad credit concurrence, and for being consistent with country's macroeconomic framework and payment prospects.

2) **Strengthening the Financial Instruments**

With this in view, following suggestions can be made:

i) Finance must be conditioned on a policy framework strong enough and timely enough to restore confidence. An institution's resources cannot compensate for a lack of policy credibility, and lending official resources to fund an inadequate policy efforts may make the situation worse.

ii) The scale of finance provided has to be calibrated to the needs, an the needs can we substantial in today's world. The BW institutions can only fill part of the gap, but there have to be able to fill a credible share of the gap if these have to play a successful part in catalysing other resources to flow.

iii) Flexibility to structure programmes appropriate to the circumstances and the borrower's policy effort is essential. The BW institutions need to be able to substantially frontload financial packages, when this is warranted. Making available small trenches of resources over the life of a programme does little to address the realities of open emerging market economies facing liquidity problems. Rather than the classis staircase pattern of disbursements, the institutions should consider, in some cases, providing a larger up front trance that floats and is available it stress materialises and policy is responding appropriately.

iv) The BW institutions should stand ready to support countries in pursuing reasonable restructuring proposals when narrated by the circumstances. Official financial resources in that context an be helpful in meeting some targeted needs.

v) The institutions need a more credible capacity to withstand arrears, so that these do not face the reality or the perception that these can be induced to accept weak programmes only to allow them to refinance their exposure.

3) Changing the Surveillance Framework

Part of the challenge entails reorienting surveillance, the process through which the BW institutions policy advice is delivered, to make it more effective. The surveillance features of today has a number of features that make it poorly suited to a small open emerging market economy that fragile credibility, a limited buffer against shocks, and considerable exposure to a rapidly changing economic and financial environment. Surveillance does not provide a meaningful check on *ex ante* policies, and resources are only made available when the financial need to acute. Access to supplemental resources on a precautionary or contingent basis could make a critical difference in preventing short-term liquidity crisis from becoming full-scale solvency problems leading to default. Of course, access to such contingent financing should be limited to countries whose policies were judged reasonably sustainable, and consistent with a reduction in balance sheet risks over time. With an enhanced surveillance framework designed to help keep policy on a stronger path that does reduce risk over time, and with contingent finance that could be mobilised quickly, the institutions would be better positioned to contain the risk of deeper financial crisis.

4) Market-Friendly Reforms

One main shortcoming of present development cooperation is that recipients of development cooperation is that recipients of development finance are denied any form of protection usual in all other cases. This shows in cases of violation of membership rights as well as regarding professional best practice. Damage done by grave negligence must always be compensated unless done the contest of development cooperation. Donors and multilateral institutions are totally exempt from any liability. The increased role of the BW institutions in international capital markets since 1982 contrasts sharply with a total lack of financial accountability. They may and often do gain institutionally and financially from crisis or from their own errors and failures, even if they cause damages by grave negligence. Another loan may be granted to repair damages done by he first loan, increasing the institutions income stream – a severe moral hazard problem and an economically totally perverted incentive system.

International financial institutions should be held financially accountable, differentiating between programmes and projects. To increase BW institutions efficiency and to improve their role in capital markets, market incentives must be brought to bear. The international public sector must become financially accountable for their own errors in the same way as consultants are liable to pay damage compensation if / when negligence on their part causes damage.

5) Emulating the Private Sector

The principle of corporate governance need be applied to the BW institutions.

IMF

The most important issue to how to reform the countries quotas in the IMF and the chairs in the Executive Board of the fund to provide greater representation to Asia and Africa. Give the growing roles of Asia in the global economies, Asian policy makers have correctly complained about a system of distribution of power within the IMF that does not recognise their growing role and, in part, they have developed institutions for Asian financial cooperation a reaction to their frustration for the lack of recognition of their growing global role. There is room for a creative solution: Unify the Chairs currently held by the Euro members, thus reducing the number of European Executive Directors, reallocate the existing quotas, reduce the quotas of

the European countries to reflect the change in important and power of other regions. Thus, there is now room – and meaningful livelihood for some creative reform that will deliver a more representative IMF in the 21st Century.

Check Your Progress 2

1) Explain the need for Bretton Woods Institutions in this age of globalisation.

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2) What should be the role of Bretton Woods Institutions in the present times?

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3) Make suggestions to improve the working of the Bretton Woods Institutions.

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18.7 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA) AND INTERNATIONAL FINANCE CORPORATION (IFC)

To end this unit on Bretton Woods Institutions, we give a brief profile of the working of the IDA and IFC, two associates institutions under the World Bank umbrella.

18.7.1 Working of IDA

IDA is an associate of IBRD. It was established in 1960 to provide 'soft loans' to economically sound project which creates 'social capital' such as the construction of roads and bridges, slum clearance and urban development. The projects taken by the IDA are such that fall under the category of high development priority due to their benefit to the development of the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects interest-free and for longer periods. Therefore, IDA is often referred to as the 'sot loan window' of the World Bank.

The IDA extended assistance to high priority projects in the member-countries. The finance may we made available to the member-governments or to the private the enterprises. Lending to private enterprises may be made without government guarantees. It also cooperated with other international institutions and member-countries in providing financial and technical assistance to the less-developed countries.

The financial assistance of the IDA has some special features.

- The credit is interest-free. Only a small service charge of 0.75% per annum is payable on amount withdrawn and outstanding to cover administrative expenses.
- Repayment period is long-extending over 50 years. There is an initial moratorium for 10 years and the amount borrowed is repayable in the next 40 years.
- IDA finances not only the foreign exchange component but also a pat of the domestic cost.
- The credit can also be repaid in the local currencies of borrowing countries. Thus, the repayment of loan does not burden the balance of payments of the country.
- Only the poorest among the poor countries are eligible for assistance.

All members of the IBRD are eligible to become members of the IDA. The members are grouped into two. Part I consists of industrially developed countries whose subscription can be freely used or exchange for other currencies by the IDA. Part II lists consists of other countries who are required to contribute 10% of their subscription in the forms of other currencies and the rest of their own currencies. Contributions in the form of national currencies by these countries are not to be used by the IDA for conversion to other currencies or for financing exports form these countries without the consent of the country concerned.

IDA has been a blessing for the developing countries to whom the credit from the IDA has largely gone. The agency brings significant amounts of investment to the poorest countries on much easier terms than would otherwise be attainable. Importantly, it also serves to separate out the worst risk, protecting the World Bank's treasured A bond rating and thus allowing it to borrow in world credit market at the most favourable terms. In keeping with the objectives, most of the assistance has gone to high development priority projects which could not get finance from other sources.

18.7.2 Working of IFC

The IBRD loans are available only to member-country governments or with the guarantee of member-country governments. Further, IBRD can only make a loan but it cannot participate in the equity of the financed project. IFC was established in 1950 with the specific purpose of financing private enterprise. It is an affiliate of the IBRD. The Board of Governors of the IBRD also constitute the Board of Governors of the IBRD also constitute the Board of Governors of the IFC. But it is a separate entity with funds kept separate from those of the IBRD.

The purpose of the IFC is to further economic development by encouraging growth of private enterprise in member-countries, particularly in the less-developed areas, thus supplementing the activities of the IBRD. The IFC, therefore:

- Invests in private enterprise in member countries, in association with private investors and without government guarantee, in cases where sufficient private capital is not available on reasonable terms.
- Seek to bring together investment opportunities, private capital of both foreign and domestic origin, and experienced management; and

The IFC makes advances in the form of long-term loans or invests in the equity shares in a wide variety of productive private enterprises in developing countries. It particularly encourages joint ventures between developed and developing countries, the technical skill available with the former combining with the resources available with the latter. The project which IFC proposes to assist should be economically viable one and beneficial to the economy of the member-country. IFC's investment normally does not exceed 40% of the total investment of the enterprise. In case of its investment by equity contribution, it does not exceed 25% of the share capital. The interest charged on advances varies depending upon the proposal and status of the borrower.

The resources of the IFC consist of capital contributed by its members. It can also borrow from the World Bank for the purpose of lending. It can also float its own loans in world capital markets.

The IFC had a slow beginning and much of its assistance was concentrated in Latin and Central America Countries. But in recent years it has diversified its area of operation and many developing countries stand benefited.

Check Your Progress 3

1) How is IDA different from / related to IBRD?

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2) Examine the Working of the International Development Association.

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3) Examine the working of the International Finance Corporation.

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18.8 LET US SUM UP

For the last 60 years the Bretton Woods institutions have played and still play an essential role in ensuring global financial stability and fostering economic growth and development. A strategic review of their functions and roles is thus important to ensure that they maintain – in the next 60 years – the crucial and essential roles that have played until now.

18.9 KEY WORDS

Externalities : These are variously known as external economies and diseconomies, spill over and neighbour effects. Externalities involve an inter-dependence of utility and / or production functions. A beneficial externality arises where an externality – generating activity raises the production or utility of the externally-affected party. An external diseconomy is where the externality-generating activity lowers the production or utility of the externally – affected party.

Market Failures : The inability of a system of private markets to provide certain goods either at all or at the most desirable or 'optimum' level.

International Payments Systems : A general term referring to the way in which international financial transactions are carried out, that is payments between residents of different countries who hold different domestic currencies.

Special Drawing Rights : It is an accounting creation without any backing, which, subject to a variety of conditions, debtor countries may use to settle debts.

Conditionalties : The terms at which loans are extended by the IMF.

18.10 SOME USEFUL BOOKS

Grabbe, J. Orlin, *International Financial Markets* (Prentice Hall, New Jersey)

Dhingra, Ishwar C (2007) *The Indian Economy: Environment and Policy* (Sultan Chand, New Delhi,).

Soderston B. and Geoffery Read, *International Economics*, (Mac Millan, London).

Salvatore Dominick, *International Economics* (Prentice Hall, New Jersey)

Bhagwati, J.N., *Dependence and Inter-dependence* (Cambridge, M.I.T).

http://www.imf.org

UNIT 19 REGIONAL FINANCIAL INSTITUTIONS

Structure

19.0 OBJECTIVES

After going through the Unit, you will be able to:

- define and explain the working of customs unions currency areas;
- define and explain the working of optimum currency areas;
- analyse the growth of regional financial institutions; and
- describe and assess the development of the European arrangements regarding the evolution of customs union, and later, currency unions.

19.1 INTRODUCTION

You have read about regional international trading blocs in Block 5 Course MEC 007 International Trade and Finance. This unit deals with regional financial institutions which are institutions working in a group of nations. Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. But we explore in a greater part of the unit how a group of nations comes together to engage in foreign trade and international financial dealings among each other using arrangements that may be thought to be substitutes for the fixed exchange rate system that you studied in Unit 17.

We will explain the theory of customs unions in the next section. These unions are basically arrangements where a group of nations do away with tariff and non-tariff barriers among themselves but apply these to countries outside the group. The subsequent section deals with currency unions and optimum currency areas. These are areas where the member countries agree to share a common currency. The monetary or currency union is an extension of the fixed exchange rate that seeks to avoid the instability associated with the fixed exchange rate system. The section after that deals with regional financial institutions, which are financial institutions that

lend at the level of a few nations, or one continent. An example is the Asian Development Bank (ADB). The final section discusses the evolution of Europe in the post-World War II period from being a customs union to moving towards a monetary union with a common currency. This section is an application of sections 19.2 and 19.3 on customs union and currency unions, respectively.

19.2 THE THEORY OF CUSTOMS UNION

A customs union is an association of two or more countries to encourage trade. The countries making such an arrangement agree to eliminate tariffs and other restrictive regulations on trade among them. It is a discriminating trade arrangement since the liberalisation only includes the countries that are members of the customs union and they formulate and administer a common foreign trade policy in regard to tariffs and other trade restrictions against third countries.

The best-known customs unions have included the Zollverein, which was created by Bismark, Benelux and the EEC, which later came to be called the EU. The Zollverein was formed by German states in the 1830's. These states became the German nation in 1871. Belgium, the Netherlands and Luxembourg established Benelux in the 1940's. Belgium, France, Italy, Luxembourg, the Netherlands and West Germany set up the EU in 1957. We will discuss about the European case in greater detail in Section 19.5.

The first systematic analysis of customs union was provided by Jacob Viner. He looked at the situation for a group of countries before and after they joined the union. In what circumstances would countries gain by forming a customs union? How will trade patterns and resource allocation be affected? According to Viner, after the formation of the union, some member would be importing from others but which it formerly did not import because the price of the protected domestic price of the product was lower than the import price. With the formation of the union, protection to domestic industry would be removed. There will be a shift in the locus of production from a high cost to a low cost point. This would be appreciated by those who champion free trade. Viner called this outcome *trade creation*. There could be a second kind of effect of the formation of customs union, according to Viner. After the formation of the union, there may be commodities which a member would be importing from some other member, which it earlier used to import from a low-cost *third* country, because that was the cheapest source of supply, even after payment of duty. After the union, this same product may be purchased from another member of the union. The shift of production in this case is not now between two member countries but between a low-cost non-member country and high-cost member country. This kind of effect Viner called *trade diversion*.

According to Viner, when trade creation is dominant and trade diversion not so prominent, the formation of the union raises the collective welfare of its members. Some member may experience a loss, but the joint welfare of others will outweigh the loss. Moreover, the non-member countries may experience some welfare loss, but the welfare of the members will outweigh that loss. On the other hand, if trade diversion is dominant, a customs union may reduce the welfare of its members.

Viner's analysis had three limitations. First, he did not show how to deal with a trade-off between trade creation and trade diversion. Secondly, he assumed a case of constant returns to scale. Finally, he considered only production effects, and did not analyse consumption effects which modern tariff analysis explicitly brings into

the picture. Traditional customs union theory builds on relatively strict assumptions such as perfect competition in commodity and factor markets and hence it is often referred to as orthodox customs union theory. It also only deals with the static welfare effects of a customs union. It has both positive and negative welfare effects, compared to a situation in which every member state practices protectionism. Therefore no conclusion can be drawn in advance as to the net welfare result of a customs union. The term 'orthodox customs union theory' is due to the relatively strict assumptions of this theory, i.e., perfect competition in the commodity market and factor markets, perfect factor mobility within individual countries but not among the countries, foreign trade equilibrium and full employment. The opportunity cost in production is reflected in the relative commodity prices in each country and transport costs are not included since tariffs are assumed to be the only kind of international trade barrier.

Later theories have attempted to deal with these limitations of Viner's theories. Customs union theories can be analysed in the same way as partial equilibrium analysis of the effects of tariffs. We now compare customs union with free trade zones. Both customs union and free trade zones are examples of **preferential trading agreements** under which member countries apply lower tariffs on each other's goods than on the same goods coming from other countries. In a customs union, the countries must agree on the tariff rates. In a free trade area, on the other hand, each country's goods can be shipped to the other without tariffs, but in which each member country sets tariffs against the outside world *independently*. The North American Free Trade Agreement (NAFTA) is a free trade agreement between the US, Mexico and Canada. Canada and Mexico need not agree, for example, on tariff rate on electronics goods from Japan. The European Union is a customs union. Free trade area is politically simple but administratively complex while a custom union is the opposite. For example, tariff administration is easy in a customs union. Goods must pay tariffs when they cross the border of the union but can be freely shipped from there onward.

Check Your Progress 1

1) What is a preferential trading agreement?

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2) Explain the difference between trade creation and trade diversion effect of a customs union.

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3) Bring out the difference between customs union and a free trade area.

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19.3 CURRENCY UNIONS AND OPTIMUM CURRENCY AREAS

You have studied about the relative merits of fixed and flexible exchange rates in unit 17. One alternative to fixed exchange rates is for a group of currencies to form a common currency. This Section explains the working of monetary unions and common currency areas. The Section also examines the case for and against optimum currency areas. Countries are facing external economic shocks all the time. By changing its exchange rate, a country can lessen the disruptive effect on its economy. If the country has a flexible exchange rate policy, it can have some potentially harmful effects, like making prices volatile, and governments not being able to check inflation. So a country might like to get the same type of benefits that are conferred by the fixed exchange rate system, and avoid the rigidities at the same time. This is possible through an optimum currency area. The basic theory of currency unions was put forward by Robert Mundell, who later went on to win a Nobel Prize for his work

A country's costs and benefits from joining a fixed-exchange area depend on how well integrated its economy is with its potential partners. The theory of optimum currency areas suggests that fixed exchange rates are most appropriate for areas closely integrated through international trade and factor movements. A major benefit of fixed rates is that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions as compared to floating rates. The monetary efficiency gain from joining the fixed exchange rate system is the comparative saving from avoiding the uncertainty and transactions costs that arise from floating exchange rates. A high degree of economic integration between a country and a fixed-exchange rate area *amplifies* the monetary efficiency *gain* that accrues to the country when it pegs its exchange rate against the area's currencies. Another reason why high integration with a fixed exchange area increases a country's benefits from joining the area is economic integration leads to international price convergence and hence lessens the scope for independent variation in the pegging country's price level.

Membership in an exchange area may involve costs as well, even when the area has low inflation. These costs arise because a country joining an exchange rate area gives up its ability to use the exchange rate and monetary policy for the purpose of stabilising output and employment. This economic stability loss from joining like its benefits from joining is related to the country's economic integration with its exchange rate partners. Now, a basic result is that a high degree of economic integration between a country and the fixed exchange rate area it joins *reduces* the resulting economic stability loss due to output market disturbances. This finding as well as the previous one about high degree of economic integration increasing the benefits of a country joining a fixed-exchange rate area explains the existence of optimum currency

area which is a region with economies closely linked by trade in goods and services and factor mobility.

An **optimum currency area (OCA)**, also known as an **optimal currency region** (**OCR**), is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. An optimal currency area may often be larger than a country. For instance, part of the rationale behind the creation of the euro was that the individual countries of Europe did not each form an optimal currency area, but that Europe as a whole does form an optimal currency area.

The main characteristics of an optimum currency area are:

1) Labour should have free mobility across the region. This includes physical ability to travel (visas, worker's rights, etc.), lack of cultural barriers to free movement (such as different languages) and institutional arrangements (such as the ability to have pension transferred and to the new region).

2) Openness with capital mobility and price and wage flexibility across the region. This is so that the market forces of demand and supply automatically distribute money and goods to where they are needed. In practice this does not work perfectly as there is no true wage flexibility.

There should be an automatic fiscal transfer mechanism to redistribute money to areas/sectors which have been adversely affected by the first two characteristics. This usually takes the form of taxation redistribution to less developed areas of a country/region. This policy, though theoretically accepted, is politically difficult to implement as the better-off regions rarely give up their revenue easily.

Additional criteria that have been suggested for a region to be called an OCA by some economists are: there should be (a) production diversification (b) homogeneous preferences and (c) commonality of objectives The classical case for optimum currency areas assumes not only a similarity among participating countries, but also a high level of economic integration among participating countries. This theory has been most frequently applied in recent years to the euro and the European Union. By the above criteria the European Union does not constitute an Optimal Currency Area and therefore the Euro should not be a successful union of currencies. Although the developing world's experience with monetary unions has been neither abundant nor successful, European monetary integration has led to some initiatives for forming monetary unions in the developing world. The initiative taken by the members of the Gulf Cooperation Council stands out in this regard.

Check Your Progress 2

1) Explain why country that is already closely economically integrated with a fixed-exchange rate area will gain from joining the area as a member.

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2) Explain what an optimum currency area means. How does it work?

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3) What are the two main characteristics of an optimum currency area?

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19.4 GROWTH OF REGIONAL FINANCIAL INSTITUTIONS

We find many levels of groupings of nations in the international arena. Groups of countries that share borders often have semi-permanent cooperation agreements on immigration and customs and possess institutions that implement these. Other groupings of countries come together on the basis of and to advance an ethnic, a geographical and or a cultural identity. Institutions like the UN, the World Bank and IMF are global institutions. You studied about global Bretton Woods institutions like the World Bank and IMF in the previous unit.

There is a particular type of grouping that is relatively large in terms of country coverage without being global, and one that deploys primarily financial instruments to advance its objectives. These are the Regional Financial Institutions (RFI's) Regional financial institutions are institutions that have financial dealings in a certain region rather than at a global level. For instance, the Asia Development Bank operates to assist financially countries in Asia and the Pacific. An important characteristic of these institutions is that both rich and poor countries are their members. The rich nations are usually donors and the poor the recipients. In other words, these institutions are primarily designed to be agents of development assistance. In some ways, the, RFI's are smaller scale versions of fully global financial institutions (GFIs), particularly the World Bank. The operations of the RFI's and GFI's may sometimes overlap in some countries.

There can exist, theoretically and actually, groups of firms, and groups of countries. There sometimes arise in these groupings, economies of scale as well as economies of scope. The size of the institutions will be determined by marginal costs and benefits of size, which will in turn depend on the specifics of the socioeconomic situation being discussed. Taking the perspective of costs and benefits, of scale and scope, we can ask as to the rationale for the co-existence of RFI's and GFI's, especially when 'development assistance resources' may be scarce. If there is such a rationale, is the current mix of RFI's and GFI's optimal? The issue is division of labour between RFI's and GFI's, and how both types of institutions can increase their effectiveness.

There are mixed motives for the donor countries to provide development assistance to developing nations. While a desire for poverty alleviation may genuinely be present, there is also narrow self interest, as is sometimes seen in the case of tied aid. There are also foreign policy interests. But we can still look at the advantages and disadvantages of alternative institutional arrangements for development assistance. One case is bilateral assistance. In this case the donor country's 'taxpayers' can closely monitor their aid in the developing country. The disadvantages also arise from this same source—domestic political processes in the donor country, and domestic distributional struggles, affect and influence the nature and composition of development assistance. This is seen in the various pressures that come on a government to tie its aid to purchases from its own suppliers.

We turn to the issue of whether a group of donor nations should come together multilaterally. In principle, a pooling of resources in a rich donors' group should have considerable cost advantages. However, pooling of countries in turn introduces the problem of differences in preferences of the different members on how the resources should be used. Whatever consensus is reached, it will always be unsatisfactory to some countries' preferences as donors. The cost advantages therefore have to be balanced against this disadvantage. Therefore, a rational response for each donor country will be to diversify, to have some of its development assistance flow through bilateral channels and some through channels that group together rich country donors. This argument has not as yet provided a rationale for RFI's, since it discusses groupings of donors, not groupings of recipients. What are the costs and benefits of grouping recipients into groups that are defined by geographical region? The cleanest argument comes from a consideration of cross-border externalities and multi-country public goods. When development in or actions by one country have an impact on other countries, an impact that is not mediated by competitive markets, the presence of such an externality can lead to sub optimal policy outcomes for the group of countries encompassed by that externality.

The above argument suggests a demarcation of tasks: regional externalities to be dealt with by regional institutions, global externalities by global ones. In other words, RFI's should supply regional public goods (RPG's), and GFI's should supply global public goods (GPG's). Of course the division is not clear-cut.

There are five policy suggestions that have been made regarding regional financial institutions. First, the responsibility and resources for region specific public goods should be gradually and increasingly shifted to the RFI's. To the extent that the RFI's do not have the capacity to deliver on these just yet, a purposive programme of building up these capacities should be developed. Second, global issues such as green house gases, financial contagion, global spread of diseases, etc., should remain the domain of global institutions. But these may not be explicitly financial institutions.

Third, on country specific operations there should be a presumption in favour of donor resources flowing through RFI's rather than the World Bank. This does not necessarily mean that the World Bank end country-specific operations. Fourth, there should be a presumption that the lead role in interacting with a government in developing and monitoring conditionality should fall to the RFI's rather than the GFI's. And finally, in certain situations, a case could be made for *sub*-regional financial institutions for further improving the division of labour.

Regional development financing arrangements have been of three basic types.

The oldest and best-developed type is multilateral development banks and related

multilateral financial institutions. These institutions are present in all regions, although with different coverage, structures, and priorities. A second type, which is usually used by the European Union, is fiscal transfers with explicit redistributive regional objectives. A third and more novel type is the development of regional bond markets; East Asian countries have taken the most significant steps in this regard.

Regional financial cooperation faces significant challenges, which must not be underestimated. They relate to the viability and long-term sustainability of the arrangements that are created, and involve three major issues: the capacity of a given group of developing countries to supply the relevant financial services; the need to guarantee that strong regional institutions are developed; and an equitable distribution of the benefits of regional integration.

19.5 EUROPE: A CASE STUDY

Let us now see how events unfolded over the decades in Europe that led to monetary unification in terms of a single currency and single central bank. At the very beginning Europe undertook steps in this direction by forming a customs union. European attempts at regional integration started soon after the Second World War when there was a common realisation among these countries of the need to rebuild their war-affected economies. Moreover, the United States through the Marshall Plan for the reconstruction of Europe. The US urged the European governments to combine their economic and political resources. At first, Europeans adopted a sectoral approach. The European coal and Steel Community was created, freeing trade in coal and steel. Then efforts were directed towards the creation of a full – fledged customs union, an arrangement under which all trade barriers among these countries would be abolished, and a common external tariff for other countries would be adopted. In 1957, six countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) signed the treaty of Rome, establishing the common market in 1958. Monetary cooperation in Western Europe began before the creation of the common market in 1958 but efforts in this direction were stepped up in the later period. The customs union was completed in 1968. in 1973, Britain was admitted to the EEC. The EEC adopted a Common Agricultural Policy (CAP) in 1968, setting uniform prices for farm products and imposing variable levies on imports.

Current account convertibility came early (in 1958, coinciding with the launch of the Common Market), capital account liberalisation came late, and was part of a gradual process that did not culminate in the collective removal of capital controls until 1990. This was soon followed by a major crisis in 1992. It thus became clear that exchange rate stability required a full-fledged movement toward monetary union. This was combined with the Stability and Growth Pact, which established explicit fiscal rules and convergence criteria.

Europe's move towards a common currency area started in the late 1960s when the Bretton Woods system started showing problems and there were currency crises. In 1969, European leaders met at The Hague and appointed Pierre Werner, Prime Minister and finance minister of Luxemburg to head a committee that would outline concrete steps for eliminating intra-Europe exchange rates, lowering trade barriers and centralising EU monetary policies. The Werner Report was adopted in 1971 . In March 1979 was formed the European Monetary System. It was a mutually pegged exchange rate system consisting of eight members originally: France, Germany, Italy, Belgium, Denmark, Ireland, Luxembourg, and The Netherlands. This system worked to restrict the exchange rates of participating currencies within

specified fluctuating margins. The EMS went through periodic currency realignments. Eleven realignments occurred between 1979 and 1987. events of 1990 when reunification of eastern and western Germany took place. This led to huge spending and fiscal expansion by Germany as well as borrowing and there was high inflation in that country. The German Central Bank, the Bundesbank raised interest rates to stem inflation. Other EMS countries like France, Italy and Britain were not growing fast, and they did not want to raise interest rates as that might have lowered real investment and pushed their economies into recession. They also did not want to devalue their currencies. The result was a series of speculative attacks on the EMS exchange parities. By 1993 the EMS was forced to retreat to very wide bands which stayed till 1999.

The process of developing a common market that was started in 1957 when the EU (then called EEC) formed the customs union, was still incomplete in the late 1980s. There were government imposed standards and licence requirements in some countries. There were significant barriers to factor movements. In June 1985, the EU's executive body, the European Commission decided to work towards removing all barriers to trade and capital and labour movements by 1992.

The early EMS had frequent currency realignments and widespread government control over capital movements. This led to significant manoeuvring for national monetary policies. In 1989, a committee headed by Jacques Delors, president of EC, recommended a transition to an economic and monetary union (EMU) and eventually to a single currency. This was followed by a meeting of the leaders of the EU on December 10, 1991, at the Dutch city of Maastricht and a decision there to place the EU on the path to EMU.

The EU countries moved away from the EMS towards the more ambitious goal of a single shared currency for four reasons. First, it was believed that a single EU currency would produce a greater degree of European market integration than fixed exchange rates by removing the threat of EMS currency realignments and removing the costs of currency conversion. The single European currency was seen as a necessary complement to the 1992 plan for unifying EU markets into a single, continent-sized market. Secondly, Germany's actions after 1990 and its position made some countries feel that EU's goals were being substituted by Germany's goals at the cost of their benefits. They felt the need of a European Central Bank. Third, given the wide freedom of capital movements within the EU, it seemed not a good idea to keep national currencies with fixed parities; rather it was felt that a unified, single currency would be better. if the goal was to combine permanently fixed exchange rates with freedom of capital movements, a single currency was the optimal solution. Finally, it was hoped by leaders of EU, the participants in the Maastricht Treaty, that the Treaty's provisions would guarantee the political stability of Europe. A single currency was seen as signifying greater political cooperation as well.

The Euro is the name that has been given to common official currency unit of 12 European countries, namely, Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Portugal, Spain, and The Netherlands. These 12 countries along with the three other counties who are not part of the official currency unit of the euro, namely, Britain, Denmark and Sweden as you know constitute the European Monetary Union. These three countries are not part of the euro. The euro was formally introduced on January 1, 1999. At that time Greece was not a member, and joined two years later. During the period between January 1, 1999 and December

31, 2001, the respective national currencies of these countries continued to be legal tender, but their governments issued debt in euro.

The birth of the euro resulted in fixed exchange rates between all European Monetary Union nations. Not only did the countries have a fixed exchange rates system; they even had a common currency and a common Central bank. They thus gave up more sovereignty than a normal fixed rate regime entails. The European Central Bank was inaugurated on June 30, 1998, with its headquarters in Frankfurt. This Bank replaced the European Monetary institute.

Check Your Progress 3

1) What is the basis you would suggest to get the optimal mix of activities between Regional Financial Institutions and Global Financial Institutions?

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2) What have been the basic types of regional financial arrangements?

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3) Briefly state the basic reasons why the EU nations decided to move away from the EMS to the goal of a shared single currency?

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19.6 LET US SUM UP

In this unit, we continued our discussion of international financial relations that we had started in Unit 17. The unit discussed trading and financial relations for a group of nations who trade together as a block. The unit began with the theory of customs union. The basic assumptions were clearly stated and the workings of these unions were discussed. The advantages and disadvantages of these unions were assessed. Subsequently the unit went on to discuss the theory of optimum currency areas. The economic gains for the members were discussed and the political implications were touched upon.

The unit then discussed in great detail the history of the European experience, how Europe experienced a common market, a customs union, and later made moves towards an optimum currency area, and subsequently, made a move towards a common currency and common central bank. Various evolving arrangements and agreements in this regard were described. Finally, the unit did a regional version of the analysis of the previous unit. While Unit 18 talked of Bretton Woods institutions, the present unit talked of regional financial institutions. We saw why they exist and what functions they perform, and to what extent they are able to help nations that deal with these institutions.

UNIT 18 THE REGIONAL ORGANIZATIONS : EU, ASEAN, APEC, SAARC, OIC AND OAU

Structure

18.0 OBJECTIVES

This Unit deals with six major regional organizations. Like the UN, these organizations are playing a decisive role not only in political or economic matters at regional level but also at the international level. As the world is becoming more interdependent, national barriers are getting weakened and nations of a particular region are forming their own associations. This process is still continuing. After going through this unit you should be able to :

- explain the origin, objectives or functions and structure of major regional organizations or groupings;
- gain an overview of their changing role in regional or international politics;
- examine some of their major accomplishments and shortcomings.

18.1 INTRODUCTION

Unlike the global international organization, regional international organizations and institutions are created to perform specific or limited functions for a group of countries which are united by some geographical, cultural or historical factors. These States of a particular region may unite themselves in group or organizations for economic and political ties or for political ideology and similarity of social institutions. Experience of such regional organizations may be useful for governments and peoples to appreciate the benefits of international integration and international confederal arrangements. Such experience may

also teach them to develop the intergrative political habits and skills for possible application on a larger scale and for a broader range of functions.

Since the end of World War II many regional organizations have been established in the various regions of the world. This unit discusses the following ones.

18.2 EUROPEAN UNION

The European Union (EU) was previously known (till 1992) as the European Community (EC) or the European Economic Community (EEC). It is a closely-knit group of 15 European States. It was created to foster greater economic and political integration in Europe, to help them avoid another war among them, like World War II. These 15 members of EU, having a collective population of 370 million, share the common institutions and policies that have brought an unprecedented era of peace and prosperity to Western Europe. The EU is in many ways unique among the attempts towards fostering supranationalism among the people in its member countries. In fact, its unprecedented success story has served as a model for other similar experiments.

18.2.1 Origin, History and Objectives

Before and after the World War II many efforts were made to create unity among European States on institutional basis. However, the origin of EU can be traced directly to the year 1952, when six countries – Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and The Netherlands – decided to create the European Coal and Steel Community (ECSC) by pooling their coal and steel resources in a common market controlled by an independent supranational authority. A major landmark, however, came in 1958 when the Treaties of Rome (1957) entered into force. The Rome Treaties established the EEC and the European Atomic Energy Community (Euratom), extending the common market for coal and steel to most other economic sectors in the member countries. The basic objective of these treaties was to establish gradually a European Common Market with the eventual free movement of goods, persons, services and capital among the EC countries.

In 1973, three other countries – UK, Ireland and Denmark – joined the EC. From Nine in 1973, its membership has risen to 15 by 1 January 1995. Others joining it were Greece (1981), Spain and Portugal (1986), Australia, Finland and Sweden (1995).

Many significant developments occurred between1958 and 1992 which enabled the EC to be transformed into what it is now known as EU. In 1973 the Constitution of the European Monetary Co-operation was signed. From 1999 the European Monetary System starts to operate. The single European Act (1986) and the Maastricht Treaty on European Union (1992) were milestones in the history of EU. The former entered into force in July 1987 and the latter on 1 November 1993. The former envisaged the creation of a single market by 1 January 1993. The Maastricht Treaty sets into motion an ambitious programme: a common or single currency at the earliest by 1 January 1997 or the latest by 1 January 1999; a European Central Bank, a common foreign and security policy and internal security and the European citizenship. Its task is to mould the Member States into a single Community embracing every sector of the economy covering such key areas as the free movement of goods and workers, freedom of establishment and services, the free movement of capital and payments, competition policy, economic and monetary policy, environmental policy, research and technology and industrial policy.

The introducing of Union (European) citizenship can be considered as the most important feature of Maastricht Treaty. It gives Union citizens the right to live, study or spend their retirement in any Member-State. Originally the right to freedom was restricted to workers only, but now everyone can benefit from it. Union citizens have the right to vote and stand as candidate in municipal elections in the Member State where they reside. This has major

implications. Indeed some Member States had to amend their constitutions to make it possible. It should be noted that the Union citizenship stands alongside national citizenship so that people can still retain their national identity. However, it must be acknowledged that the Union citizenship is one of the innovations introduced by the Treaty showing how the EU is gradually evolving from an economic community into a political union.

18.2.2 Institutions or Organs

The EU functions through seven organs. They are :

1) **The Council of the European Union** is the main decision - making institution. It is made up of Ministers from the 15 Member States. Different Ministers attend Council meetings depending on the agenda. It enacts Union Legislations (regulations, directives and decisions). Its decisions are binding throughout the EU territory and it directs inter-governmental cooperation. The Presidency of the Council rotates among the Member States every six months. Each Presidency concludes with a summit of the Council which brings together the Heads of State or Government.

2) **The European Parliament (EP)** is composed of 626 members, directly elected (since 1979) to five year terms. Members of the EP (MEPs) form political rather than national groups. The EP acts as the EU's public forum, debating issues of public importance and raises questioning for the Council and the Commission. It can amend or reject the EU budget.

3) **The European Commission** : A single Commission for all three Communities (the ECSC, the EEC and Euratom) was created when the Treaty merging the executives entered into force in July 1967. The number of commissioners was increased to 20 in January 1995. The Commission proposes policies and legislation, and ensures that the provisions of the treaties and the decisions of the institution are properly implemented.

4) **The Court of Justice** interprets EU law and its rulings are binding. The Court comprises 15 judges assisted by 9 Advocates-General. It is assisted by a *Court of First Instance*, which has jurisdiction to hear cases in limited areas.
The other bodies of EU are the *Court of Auditors* (15 members), the *Economic and Social Committee* (222 members) and the Committee of the Regions (222 members). The second body represents employers, employees and many groups such as farmers and consumers, and the third one represents local and regional authorities.

18.2.3 Role and its Future in World Politics

During the last four decades the EU has emerged as the world's largest trading bloc and an economic giant. It has served as a magnet to attract new members (the applications of Hungary and Poland for EU membership are pending since April 1994) bringing its total population and GNP equivalent to those of the present and former Super Powers – the USA and the USSR. It is gradually moving towards greater European integration and federalism. It may become a *United States of Europe* in due course. It is a Super Power in the making and may fill the vacuum created by the disintegration of the USSR, the only other Super Power since 1945. Its constructive role may restore the balance of power in the present uni-polar world politics.

18.3 ASSOCIATION OF SOUTH EAST ASIAN NATIONS

The Association of South East Asian Nations (ASEAN) was formed following the signing of the Bangkok Declaration on 8 August 1967 by five States – Indonesia, Malaysia, the

Philippines, Singapore and Thailand. Brunei joined it in January 1984 and Vietnam recently. Though ASEAN came into existence principally as a result of the Vietnam war and its perceived threat to the non-communist States of South-east Asia, by admitting Vietnam (a communist State) it has overcome its earlier anti-communist bias. Like EU, it is attracting many new members. Myanmar has been given observer status at a meeting of its foreign ministers on 20 July 1996. It is expected that Myanmar alongwith Laos and Cambodia will soon join ASEAN.

18.3.1 Aims and Purposes

Seven aims and purposes were included in the ASEAN declaration. These are :

i) to accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South East Asian Nations;

ii) to promote peace and stability through binding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the UN Charter;

iii) to promote collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;

iv) to provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;

v) to collaborate more effectively for the greater utilization of their agriculture and industries, expansion of their trade including the study of the problem of international commodity trade, improvement of their transport and transport and communication facilities and raising living standards of their peoples;

vi) to promote Southeast Asian studies; and

vii) to maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes and to explore all avenues for even closer cooperation among themselves.

18.3.2 Institutions or Structure

ASEAN's highest authority is the summit of heads of government of its members States. The summits are held only when necessary, the first such summit was held in 1976 and the third and most recent in 1987. The ministerial conference is an annual meeting of foreign ministers held on a rotating basis in each country. The ministerial conferences are supplemented by bimonthly meetings of the standing committee which comprises the foreign minister of the host country and ambassadors from other six. The ASEAN secretariat was formed in 1976; the post of Secretary-General rotates among member States every three years.

Other permanent committees include : (i) trade and tourism; (ii) industry, minerals and energy; (iii) food, agriculture and forestry; (iv) transportation and communications; (v) finance and banking; (vi) science and technology; (vii) social development; (viii) culture and information; and (ix) budget.

18.3.3 Powers, Functions and Role

ASEAN provides a unified front for the member countries vis-a-vis third countries primarily in the areas of trade, development aid and some areas of foreign policy.

ASEAN's internal powers are executed in the areas of, and through, its standing and other committees. Its primary functions in these areas are the coordination of joint industrial and technical projects and the harmonization of policies, standards and regulations.

It played an important role in two areas : (1) With the aim of maintaining peace and stability in the area, it sponsored the UN Conference on Cambodia 1981. (2) In 1977 it established Preferential Trading Agreements (PTA), which resulted in the increase of intra-ASEAN trade from 15% in 1977 to 21% in 1983.

18.4 THE ASIA-PACIFIC ECONOMIC COOPERATION COUNCIL

On 5 November 1989 Asia-Pacific Economic Corporation Council the APEC was established. ASEAN members participated in its founding. APEC includes the ASEAN countries and the USA, Japan, Canada, Australia, New Zealand and South Korea. At the July 1990 inaugural meeting of APEC it was agreed to open membership negotiations with China, Taiwan and Hong Kong. The European Community-APEC relations were on the agenda for the October 1991 meeting. ASEAN reactions to the foundation of APEC (a new regional economic organization) varied from Singapore which was very enthusiastic to Indonesia which called for greater concentration on intra-ASEAN rather than external economic relations.

Check Your Progress Exercise 1

Note : i) Use the space given below for your answer.

ii) Check your progress with the answers given at the end of the unit.

1) What are the bases or reasons for the creation of regional organizations?

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2) The main features of the Maastricht Treaty are ....

(1) .....

(2) .....

(3) .....

3) The three main goals of ASEAN are ....

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(2) .....

(3) .....

18.5 SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION (SAARC)

The SAARC was formally inaugurated at the first summit meeting of the Heads of State or Government of the South Asian countries in December 1985 in Dhaka. Seven countries of South Asia – Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka – had begun discussions on regional co-operation after the initiative for such an organization had been taken by the late President of Bangladesh, Zia-ur-Rahman, in May 1980. King Birendra of Nepal is also reported to have been among those who conceived the idea.

18.5.1 Aims and Objectives

According to Article 1 of the SAARC Charter (adopted in December 1985) its main objectives are as follows :

a) to promote the welfare of the people of South Asia and to improve their quality of life;
b) to accelerate economic growth, social progress and cultural development in the region;
c) to promote and strengthen collective self-reliance among countries of South Asia;
d) to contribute to mutual trust, understanding and appreciation of one another's problems;
e) to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
f) to strengthen co-operation with other developing countries;
g) to stengthen co-operation among themselves in international fora on matters of common interests; and
h) to co-operate with international and regional organizations with similar aims and purposes.

18.5.2 Structure and Functions

i) **Meeting of Heads of State or Government** The SAARC Summit is the supreme policy making organ and meets ordinarily once a year. SAARC Summits have so far met in Dhaka (1985), Bangalore (1986), Kathmandu (1987), Islamabad (1988), Male (1990), Colomob (1991), Dhaka (1993) and New Delhi (1995). No summit meeting was held in 1989, 1992 and 1994.

ii) **Council of Ministers** consists of the Foreign Ministers of the members States. It meets ordinarily twice a year and is concerned with the formulation of policies, review of programme of co-operation etc.

iii) **Standing Committee**, comprising of Foreign Secretaries of the Member countries, is concerned with overall monitoring and co-operation, mobilisation of resources, identification of new areas of co-operation etc. It meets as often as deemed necessary but at least twice a year.

iv) **Technical Committees** comprising representatives of member-States are responsible for implementation, co-ordination, and monitoring of the programmes in their respective areas of co-operation. They submit periodic reports to the Standing Committee.

v) **Action Committees** may be set up by the standing committee. They consist of member-States concerned with implementation of projects involving more than two but not all member-States.

vi) The Secretariat, established in 1987, consists of a Secretary-General and other staff monitoring the co-ordination and implementation of programmes as well as for servicing the meetings of the SAARC organs. It is based at Kathmandu.

18.5.3 Accomplishments and Prospects

Though SAARC has completed ten years, like the other regional organizations it has not been as successful as it should have been. Progress on the generally agreed items of the SAARC agenda has been not only very slow but also unsatisfactory. It has not been able to make any significant impact on the process of cooperation and coordination in implementing the aims and objectives of the SAARC. The reasons for this state of affairs are not far to seek. The region is marred by ethnic tensions such as the Tamil-Sinhala conflict, Assamese-Bangladeshi tensions and Hindu-Muslim conflicts. In all these ethnic tensions India, as the geographical centre of the region, becomes involved. Also, historically-rooted mutual mistrust, misperception and misunderstanding among its member-States prevails. The endemic conflict between India and Pakistan is well known. Indo-Sri Lankan tension over the Tamil question or the Nepalese complaints about India's interference in her domestic affairs are other factors for tension. Moreover, as the region's largest country, there is a lurking fear of Indian domination among other members. Although external security threats do not exist in South Asia today, the problem of cross-border movements of terrorists from Pakistan to India, first in Punjab and later in Kashmir, leading to continuous tension, skirmishes, military alert and low-level proxy-war, has aspects of security concern constraining genuine regional co-operation.

Despite these problems, SAARC has been gradually moving towards greater co-operation. The seventh Summit at Dhaka in April 1993 achieved a major breakthrough. It decided to set up the South Asian Preferential Trade Agreement (SAPTA) which is a concrete step in the direction of trade liberation in the region. The SAPTA became operational in January 1996. But till in September 1996 intra-regional trade under SAPTA had not taken off as it remains hampered by a paucity of infrastructure, lack of information and prevalence of high tariff walls among its members. The attempts to throw open the borders for inter-State trade have run into trouble with businessmen in Pakistan and Bangladesh raising fears that their industries would be swamped by competition.

Since the SAARC is still in its initial stages one cannot expect quick results. However, within the existing constraints it has made some progress in regional co-operation. Its Visa Exemption Endorsement Facility is worth mentioning. Under this facility, with a view to promote people-to-people contact, visa exemption has been provided to Supreme Court Judges, members of National Parliaments, heads of national academic institutions, their spouses and dependent children from 1 March 1992. This facility allows them visa-free travel within the SAARC region.

18.6 ORGANIZATION OF ISLAMIC CONFERENCE

The Organisation of Islamic Conference (OIC) was established in May 1971, following a summit meeting of Muslim Heads of State at Rabat (Morocco), in September 1969 and the Islamic Foreign Minister's Conference in Jeddah (Saudi Arabia) in March 1970 and in Karachi (Pakistan) in December 1970.

At present OIC has 45 members: Afghanistan, Algeria, Bahrain, Bangladesh, Benin, Brunei, Burkina Faso, Cameroon, Chad, Comoros, Djibuti, Egypt, Gabon, Gambia, Guinea, Guinea-Bissau, Indonesia, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Malaysia, Maldives, Mali, Mauritania, Morocco, Niger, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Syria, Tunisia, Turkey, Uganda, United Arab Emirates and Yemen.

18.6.1 Aims and Objectives

The aims of OIC, as set out in the Charter adopted in 1972 are :

1) To promote Islamic solidarity among member-States ;
2) To consolidate co-operation among member-states in the economic, social, cultural, scientific and other vital fields, and to arrange consultations among member States belonging to international organizations; –

3) To endeavour to eliminate racial segregation and discrimination and to eradicate colonialism in all its forms;

4) To take necessary measures to support international peace and security founded on justice;

5) To co-ordinate all efforts for the safeguard of the Holy Places and support of the struggle of the people of Palestine and help them to regain their rights and liberate their land;

6) To strengthen the struggle of all Muslim people with a view to safeguarding their dignity, independence and national rights; and

7. To create suitable atmosphere for the promotion of cooperation and understanding among member States and other countries.

18.6.2 Organs of OIC

Over the years, the OIC has been actively working towards greater cooperation among its members in the field of economic, cultural, humanitarian and political matters. In this regard, it has launched programmes and has set-up the Islamic Reinsurance Corporation with authorised capital of US$ 200 million. The Organization supports education of Muslim communities throughout the world, and, through the Islamic Solidarity Fund, has helped to establish Islamic Universities in Niger, Uganda and Malaysia. In the political field, however, the organization is mainly concerned with the recognition of the rights of Palestinians and the PLO. The 1981 Summit Conference called for a *Jihad* (holy war – though not necessarily in a military sense) for the liberation of Jerusalem and the Israeli-occupied territories.
Also, this was to include an Islamic economic boycott of Israel. In the last 15 years it demanded, among others, for the withdrawal of Soviet troops from Afghanistan. In fact, the Conference had asked its members not to participate in the 1980 Olympics unless the Soviet troops had withdrawn from Afghanistan. Though it is not very successful in building cooperation and consensus in political field, it is nonetheless an important international community-group.

18.7 ORGANIZATION OF AFRICAN UNITY

The Organisation of African Unity (OAU) is one of the multipurpose regional organizations and is the largest in terms of membership. It was established in 1963. From its orginal membership of 30 it has grown to include 51 States. All members are from Africa, since the OAU Charter does permit non-African States to join. Only independent and sovereign States are admitted. After getting independence in 1990 Namibia was admitted as the 51st member.

18.7.1 Purposes and Principles

The purposes of the OAU are the following : (i) to promote unity and solidarity of the African States; (ii) to cooperate and coordinate efforts to achieve a better life for the people of

Aftica; (iii) to defend the sovereignty, territorial integrity and independence of the African States; (iv) to eradicate all forms of colonialism from Africa; and (v) to promote international cooperation with due regard to the UN Charter and the Universal Declaration of Human Rights.

The basic principles of OUA include; (i) peaceful settlement of disputes by negotiation, mediation, conciliation, or arbitration; (2) unreserved condemnation of political assassinations and subversive activities; and (3) affirmation of a policy of nonalignment with regard to all blocs.

At the inception of the OAU, Ghana led an attempt to establish a central political organization with power to formulate a common foreign policy, common planning for economic development, a common currency, and a common defence system. These suggestions, implying the surrender of national sovereignty, were unacceptable to most of the Heads of State and Government that approved the OAU Charter. The Ghanian proposal for organic political union was rejected in favour of a loose organization with a limited functional approach to unity.

18.7.2 Organs or Institutions

The supreme organ of the OAU is the Annual *Assembly of the Heads of State and Government.* The agenda for the supreme organ is prepared by the Council of Ministers, which meets twice a year to supervise the general work of the organization and which is also called into emergency session to meet with any crises. The Council is charged with the responsibility of implementing the decisions of the supreme organ. A permanent *General Secretariat carries on the continuous activities* of the organization and provides necessary support for the periodic meetings of the policy making organs. The Secretariat is headed by an Administrative Secretary General, a title that underscores the limited initiative conferred upon the officer. Five functional specialized Commissions and a Commission of Mediation, Conciliation and Arbitration complete the organizational structure of the OAU.

18.7.3 Role and Activities

The OAU does not have an impressive record of resolving regional political, economic or refugee problems. During the last 30 years it has witnessed, most often helplessly, many crises that have sometimes threatened its disintegration. Many African States have experienced civil wars and guerilla fighting. The UN-imposed sanctions against racist South African government or the earlier white-dominated regime in Rhodesia (now Zimbabwe), were often at the behest of the OAU organs pressures for effective UN action. But when it came to the actual implementation of UN resolution, the individual African States have often violated UN resolutions imposing trade embargo by continuing to have trade links with South Africa apartheid regime. However, the OAU has some accomplishments in political, economic and social matters. *First,* in 1965, in the area of economic and social cooperation, the OAU and the UN Economic Commission for Africa signed an agreement for mutual cooperation on a continuing basis to facilitate economic and social development in Africa. *Second,* in 1981, it adopted the African Charter on Human and People's Rights, which entered into force in 1986. OAU is the third regional organization (besides the Council of Europe and OAS) to have a regional human rights and mechanise to implement it.

Check Your Progress Exercise 2

Note : i) Use the space given below for your answer.

ii) Check your progress with the answers given at the end of the unit.

1) List the eight main purposes of the SAARC.

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2) Why OAU is not a very successful organization?

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18.8 LET US SUM UP

This Unit has begun with the discussion of the rationale of regional organization. It surveyed six kinds of major regional institutions, each of which have had different reasons for its creation. Thus we learnt that different reasons or factors, such as the homogeneity of interests, traditions, and values within small groups of neighbouring States, prompted their establishment. Moreover, it shows that political, economic and social integration is more easily attainable among a lesser number of States within a limited geographic area than on a global basis.

Also, this Unit has enabled us to examine some of the major accomplishments and shortcomings of these regional associations.

18.9 KEY WORDS

Regional Integration : The process whereby a group of nations or other political units shift loyalties from a national setting to a larger regional entity.

Free Trade Areas : An area where goods and products can move without tariff or custom duties.

Common Market : A customs union where labour and capital can move freely within the area characterised by product and factor integration.

Apartheid : The official policy of racial discrimination practised in South Africa till the white-minority government, which was in power for the last 50 years, was replaced by the first democractically elected non-racist government headed by Nelson Mandela in May 1994.

18.10 SOME USEFUL BOOKS

Bennett, A LeRoy, *(1988) International Organization — Principles and Issues.* 4th edn. (Eaglewood Cliffs, N.J.: Practice-Hall International).

Borchardt, Klaus-Dieter, *(1995) European Integration — The Origins and Growth of the European Union* (Luxembourg: Office for Official Publications of the European Communities).

Elazer, Daniel J. (ed.), *(1994) Federal Systems of the World — A Handbook of Federal, Confederal and Autonomy Arrangements,* 2nd edn. (London: Longman).