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INDIAN ECONOMY

Written by

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EBD_7325

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Typeset by Disha DTP Team

Reprint : March 2021

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CONTENTS

PREFACE

It gives me immense pleasure & pride in introducing my first book "The Indian Economy" for UPSC Civil Aspirants. This book is a judicious outcome of my interest in Economy and 8 years of rich experience as an IAS Educator. This book is a classic case of an Integrated approach of Understanding the Fundamentals of Economy and applying them in the current economic events that affect India. The book aims at 100% conceptual understanding for the UPSC aspirants so that they not only understand the economic events happening on a daily basis but also understand the causes and effects of the same.

Economy is a very vast subject thus it is very essential to understand the exact requirements of the Civil Services Exam before approaching it. A lot of books on Indian Economy have been written voluminously as they have not been written keeping the IAS aspirants into consideration. Thus it becomes quite tedious for the students to complete these books with fair understanding in due course of time. This book in your hand has been tailor-made for the Civil Services Prelim & Main Exams. **"uk de uk T;knk ;g ejk oknk"** is the spirit behind this book. I would like to assure all my readers that 100% of the questions in the Prelim & Main Exams would be covered in this book.

The book has been divided into 10 Units which are further divided into 21 Chapters. Each chapter discusses the Concepts in detail enriched with Real-life Examples, Mind Maps (on the most important topics) to make it easier to understand and faster to revise. The Real-life Examples captures the Current Affair happenings pertaining to India. Each chapter is followed by Previous Years Solved Prelims Questions. Mains Model Answers, written by 2019 Toppers Gokul (AIR 402) and Rahul (AIR 803), are inducted in the various chapters. In nutshell, the content has been prepared to take your UPSC CSE preparation to the NEXT Level.

The book has been written in a very student-friendly manner with a very simple language. It is the confidence of the author that this book will help you to understand the subject from scratch and will push you becoming a master of the subject. In spite of being the first edition, the book has been developed in 2 colour format for better presentation and visual appeal. I am sure that this book will act as a companion during your preparation.

Although all efforts have been made to keep the book error-free but some mistakes might have crept in inadvertently. I would request the students to highlight them so that we can remove those errors in the upcoming prints/ editions.

This book has become a reality due to the blessings of my parents and my teachers, support of my wife Jyoti,who stood by me in my thicks and thins and encouraged me to follow my passion of teaching; motivation by Muhammed AJ who pushed me very hard to write this book; Suresh Babu Sir who had put this idea in my mind long time back; Pooja my student who helped with the mindmaps; Shahan who worked tirelessly in editing the content and all my dear students who have liked my printed notes.

AMAN DEEP SONI
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Toppers' Talk about Author (Aman Soni)

TOPPERS TALK

I met Aman Soni sir in 2018 after I had failed my prelims the same year. Being a B tech graduation candidate, my economics knowledge was not up to the mark. It was under his guidance and support, I was able to gradually understand the subject in depth . His style of teaching, a simplistic but clear way of conveying ideas enabled me to be a candidate with considerable advantage in economics related questions, both in prelims and in mains. His book was my ultimate source for upsc economy related syllabus. Well updated and informative yet easy to understand description supported by pictorial depictions made the book my 24×7 companion (Lol). I pray for him as he is one of the best tutors I have ever seen in my life and I'm really proud of having recommended his books for burgeoning bureaucrats.

GOKUL RAJ, AIR : 402 (2019)

TOPPERS TALK

Aman Soni sir's classes have helped me lay a very strong foundation for the Economics classes. All the concepts are explained in detail so that it was for me to apply the logic in prelims and bring out the keywords in mains answers. He has helped me throughout the journey. His personal guidance and inputs during the interview phase also helped me a lot.

I hope this helps.

RAHUL RAJEEV, AIR : 803 (2019)

INDIAN ECONOMY
by Aman Soni

TOPPERS TALK

It was indeed a great experience to see how such a tough technical subject like economics was made easily understandable by Aman Sir and that provided the foundation for my preparation for Prelims and GS3 Mains

RAVISANKAR SHARMA
AIR 37
INDIAN FOREST SERVICE 2018

INDIAN ECONOMY
by Aman Soni

TOPPERS TALK

The handouts given by Aman Sir according to topics in GS-3 syllabus were very helpful in covering the same effectively.The revision of previous economic surveys also helped in making my answers rich in content. I thank Sir for helping me out especially with respect to GS-3 paper.

DIVYA CHANDRAN
Civil Services 2018, AIR 397

INDIAN ECONOMY
by Aman Soni

TOPPERS TALK

I was initially very weak in Economics . Before joining the classes, I had tried to prepare the subject on my own and had terribly failed at that. Aman sir literally became a Saviour for me. Sir explained all the concepts beautifully using simple examples and made the subject really interesting. He used to clear even the silliest doubts we had.

SHWETA K SUGATHAN
AIR 461 UPSC CSE 2018
AIR 34 INDIAN FOREST SERVICE 2018

INDIAN ECONOMY
by Aman Soni

TOPPERS TALK

I started understanding the articles in newspaper related to business and economics. The daily ups and downs in the market became very easy to understand. I never needed to memorize this subject as a logical modular approach was taught by Aman Soni sir.

IPSITA DATTA
DYSP WBCS 2017

INDIAN ECONOMY
by Aman Soni

TOPPERS TALK

I could feel that Aman sir makes it his personal mission to make sure that students do well. If an aspirant is ready to give 100 percent than he will definitely give his 200. He is dedicated and determined towards his students.

ASHISH CHUGH
INDIAN TELECOM SERVICE (2014)
USPC ESE AIR 30
(Assistant Director General, Department of Telecom, Ministry of Communications Govt of India)

1 Introduction to Economics & National Income

1.1 : INTRODUCTION TO ECONOMICS

Economics as a word comes from the Greek language where "Oikos" means family, household or estate and "nomos" means management. Thus household management or management of scarce resources is the essential meaning of economics.

Economics includes production, distribution, trade & consumption of goods and services. Economics is the study of how societies use scarce resources to produce valuable products and distribute them among different people.

Branches of Economics

(a) Micro Economics (Detailed study of individual entity): It examines economic behaviour of individuals such as consumers, households etc. to understand how decisions are made in the face of scarcity and what effects they will have on the larger economy. E.g. studying an automobile firm (TVS showroom in Chandni Chowk Delhi) or studying about a farmer.

(b) Macro-Economics (Overview): It studies the economy as a whole and its features like National Income, poverty, employment, etc.

Economics and Economy

Economics: It is a discipline studying economic behaviour of Humans.

It is theory. It will come out with theories of poverty, employment, etc.

Economy: It is the real life picture. It is economics in practice. It is the real picture which will come out after the same theories are practised.

Economy as such means nothing. It gets meaning once it is associated with a particular region or area. e.g. Indian Economy, US Economy, etc.

Types of Economies

Capitalist Economy

Existence of private enterprise in the main sphere of production is the main parameter for capitalism. Private Enterprise means a system of production based on private ownership of capital. Capital can be physical assets like land, factories, machines or it can be money. There is existence of concept of supply and demand by which buyers and sellers determine which goods and services will be bought and sold in the market, in what quantities and at what prices. Focus is always on profit maximization and not on the welfare of people. Capitalist economies are the type of economies in which business is largely controlled and owned by the private sector. Thus, there is virtual absence or only little presence of the public sector in economic activity. In these economies, the state plays the role of the regulator only. The private sector plays the role of investor.

Advantages of a Capitalist Economy

1. There is sufficient incentive in the form of increase in wealth for private individuals to work hard. Thus, there is overall efficiency in the economy leading to lower cost of production of various reserved commodities.
2. There are many private players producing the same output. Thus, there is a very high competition in these economies. High competition and economic incentives encourage innovation in these economies.
3. Prices are determined by markets and not by governments. Thus, prices reflect the actual value at which customers are willing to buy and sellers are willing to sell.

Disadvantages of a Capitalist Economy

1. In a capitalist economy, prices of even essential commodities are determined by market forces. Thus, the prices of essential commodities may escalate to such a level where these commodities are unaffordable for a larger section of population.
2. The private sector is the main employer. The approach of the private sector is to use minimal workforce to produce maximum output. Machines are preferred over human beings to carry out work. Thus, these economies may have large unemployment rate despite high levels of economic growth.

3. The income levels are grossly unequal. A large section of the population owns little wealth, and a tiny section of the population owns large wealth.

Capitalist economies are also liberalized, privatized, as well as globalized economies. This is because in these economies there are a few restrictions, there is high presence of the private sector, and these economies are more inter-related to other economies of the world. On the other hand, socialist economies are less liberalized, have no (or less) presence of the private sector and have no (or less) trade with other economies of the world.

Socialist Economy

Existence of public enterprise i.e., there is state ownership of capital in all important spheres of productive activity. There is centralized planning for production & distribution. Government decides what to produce according to the needs of the people. It is assumed that the Government knows what is good for the people of the country. The means of production are owned by the government. It produces everything and decides how goods are produced and distributed. Even in socialist economy, private enterprises are allowed but only for consumption and for small level of production activities.

In these economies, the state plays the role of both investor and regulator. In these economies, prices of goods and services are determined by the state.

Advantages of a Socialist Economy

1. In a socialist economy, prices of essential commodities are deliberately kept low to enable access to everyone.
2. The government is the main employer. It attempts to provide employment to a maximum number of people.
3. The income levels of large population are similar and thus there is equality in the society.

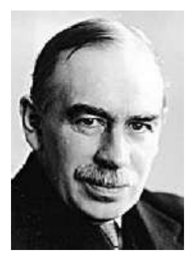
Disadvantages of a Socialist Economy

1. Economic activity is under government control. Government undertakings are usually inefficient. Moreover, there is a lack of economic incentive for private individuals other than fixed salary. Thus, there is overall inefficiency in the economy leading to higher cost of production of various commodities.
2. The whole economic output of these economies is produced by large government undertakings that have monopoly in their respective fields. Thus, lack of competition and absence of economic incentives discourage innovation in these economies.
3. Inefficiency in production causes shortage of various commodities. Consequently, black markets develop for various commodities.

Mixed Economy

Factors of production are owned by both private and public enterprises. Some firms engaged in production are owned by government & some by private owners. Though the private enterprises are owned by individual owners, they are still subject to government control. The government can regulate the working of private enterprises in India to safeguard public interest through different provisions of law e.g. treatment of industrial waste before discharging it into water bodies. Apart from publicly owned & privately owned firms, there are also firms which are owned jointly by private shareholders and government. These firms are neither wholly in public sector nor in private sector category and can be said to be in the joint sector.

Keynesian Economics



During The Great Depression of USA, an economist John Keynes said that if USA wanted to get over recession, it should follow expansionist policies i.e. the Government to come into play and start spending. Earlier Laissez Faire (meaning 'let do') prevailed in USA and the government did not interfere in the market. According to him, State can stimulate economic growth and restore stability in the economy by expansionary policies. E.g. By decreasing the tax rate, providing loans at cheaper rates of interest, by increased public spending on infrastructure. This theory is very important because it suggests ways as to how to come out of financial crisis. E.g. Quantitative Easing done by US Federal Reserve and EU Central Bank, stimulus packages provided by the Indian government between 2008 to 2010.

The Depression of 1929 showed that market wasn't perfect. Even market could fail. The intervention by the state is done in the down time of economic cycle. In the normal times, the market drives the growth.

The only drawback of Keynesian economics is that it leads to increased fiscal deficit (Fiscal deficit will be discussed in the chapter fiscal policy) and increased money in market which leads to inflation.

Keynes also suggested the capitalist economies to adopt some of the features of socialist economy. Government should provide the basic facilities.

In a capitalist economy, everything was provided by private enterprises via the market (i.e. regulated according to demand). It resulted in the capitalist getting richer & labourers getting poorer. It reduced the purchasing power of labourers & hence decreased the demand of goods. The ultimate result was great depression of 1929-1939. Due to his advice, the governments started supplying some basic goods and services called public goods to people for free or at subsidised prices e.g. healthcare, sanitation, education, etc. Prof. Lange in 1950s advised the socialist economics to adopt some features of capitalist economics and move towards market socialism but the communist political systems were stubborn and rejected the advice. It ultimately led to the breakdown of USSR but China adopted open door policy in 1978 and today it is one of the largest economies of the world.

Structural Composition of the Economy

The three sector hypothesis is an economic theory which divides economies into 3 sectors of activity. According to the theory, as an economy progresses, its main focus shifts from the primary to secondary and finally to the tertiary sector. If the economy follows this transition there is increase in employment and hence quality of life. Countries in early stage of development have low income. The main part of their national income is achieved through production in the primary sector. Countries in a more advanced state of development with a medium national income generate their income mostly in the secondary sector. In highly developed countries with high income, the tertiary sector dominates the total output of the countries.

Sectors of Economy

Primary Sector: It involves changing natural resources into primary products. Most of the products from this sector are considered raw material for other industries. It includes agriculture, fishing, forestry, mining and quarrying. It is a larger sector in developing countries.

Secondary Sector: It includes those economic sectors which create finished, usable products. It includes manufacturing & construction. It takes the output of primary sector & manufactures finished goods.

Tertiary Sector: It is the exclusion of other two sectors. (Economic activities not mentioned in the above two sectors). It is also called service sector. The tertiary sector involves provision of services to business as well as to final consumers. E.g. Transport, banking, insurance, retail, tourism, etc.

Quaternary Sector: This is an extension of the tertiary sector and includes intellectual services like I.T, B.P.O, Research and Development, consultancy etc.

Mains Model Answer by IAS Toppers

Normally countries shift from agriculture to industry and then later to services, but India shifted directly from agriculture to services. What are the reasons for the huge growth-services vis-à-vis industry in the country? Can India become a developed country without a strong industrial base?

(2014 – 200 words, 12.5 marks)

Sol. Economy matures along the sequence of first being agrarian, followed by industrialisation and later shifting to a service oriented knowledge economy. India took a different path where service sector dominates.

Factors which led to growth of services are:

- Initial boost to service sector through telecom revolution
- Globalisation aiding contact between Indian and western companies.
- Low cost of services in India made it a magnet for FDIs
- Rising middle class gave cheap English speaking workforce
- Minimum inputs required in service sector
- Factors which led to a lesser growth in manufacturing sector:
- Lack of basic infrastructure
- Unskilled labour
- Domination of public sector resulted in red tapism
- Policy Hurdles Multiple labour laws

- Policy paralysis on resource exploitation
- Friction between Industry and Environmental regulations
- Multiple permissions required
- NPAs and Credit concerns
- Competition from manufacturing economies like China

Service sector still employs just over 25%. Industry can create multiple jobs as it enables ancillary industries. Moreover, industrial sector can employ unskilled, semi-skilled and highly skilled labour. Hence, if we have to provide employment to our youth, industrial sector will have to play a major role.

Currently, our services sector is dependent on foreign clients. If we have to make the services sector growth more durable, then it should be based on domestic industrial base.

In India, agriculture employs close to 50% of the workforce. The convergence between Industry and agriculture will create remunerative jobs. E.g. food processing industry.

Finally, the purpose of growth is not to grow relentlessly but to take everyone along. Industry along with service sector would result in a sustainable economy. **(213 words)**

1.2 : NATIONAL INCOME

Final Goods and Intermediate Goods

The goods used for consumption purposes are called Final Goods. They are not used in the production of other goods. e.g. 1 kg Tomato bought & consumed by making it into a type of chutney. Here tomato is a final good. Intermediate goods are those goods which are used to make final goods. e.g. 1kg tomato bought by Kissan Sauce Company. The company makes sauce out of it and sells the sauce in the market. Here tomato is an intermediate good and sauce is final good. Only final goods are included while measuring national income. If intermediate goods were also included, this would lead to double counting.

GDP (Gross Domestic Product)

It is defined as the **market value** of all **final goods & services** produced by the factors of production located within the boundary of a country during a period of 1 year. In India GDP is calculated by **NSO (National Statistical Office)**, which comes under the Ministry of Statistics and Programme Implementation.

How to Measure GDP

Three different ways are used:

1. Output Approach
2. Income Approach
3. Expenditure Approach

Output Approach

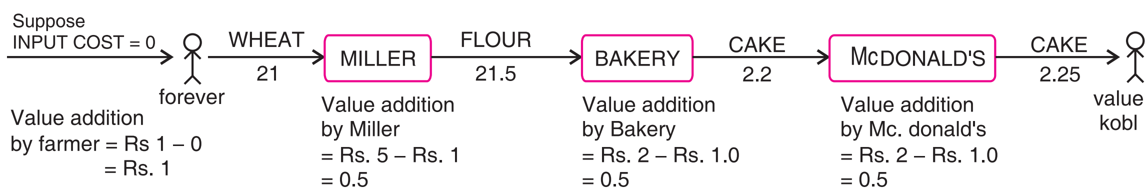
Above case is an example of an output approach. To understand the output approach, we will have to add the value of final goods & services and eliminate the value of intermediate goods (Otherwise the value of intermediate goods would cause double counting and there will be overestimation of value of GDP.

In the above case, the farmer sells wheat to the miller at ₹ 1 (we are assuming the input cost of farmer as zero).

So, value addition done by farmer = value of output (₹ 1) minus value of inputs (₹ 0) = ₹1).

Miller converts the wheat into flour and sells it to the bakery for ₹1.5 value addition by miller = value of output (₹1.5) minus value of input (₹ 1) = ₹ 0.5

Then, bakery converts this flour to cake and sells it to Mc Donalds for ₹ 2



Total value addition = 1 + 0.5 + 0.5 + 0.5 = 2.5
= 2.5 Rs. = GDP.

Factor Income for farmer	Factor Income for miller	Factor Income for bakery	Factor Income for McDonald's
Rent = 0	Rent = 10 ps	Rent = 10 ps	Rent = 15 ps
Wages = 0	Wages = 15 ps	Wages = 5 ps	Wages = 15 ps
Interest= 0	Interest= 10 ps	Interest= 5 ps	Interest= 5 ps
Profit = Rs. 1	Profit = 15 ps	Profit = 30 ps	Profit = 15 ps

Total rent generated	= 0 + 10 + 10 + 15 = 56 po
Total wages generated	= 0 + 15 + 5 + 15 = 85 ps
Total interest generated	= 0 + 10 + 5 + 5 = 20 ps
Total profit generated	= 100 + 15 + 30 + 15 = 160 ps
Total factor income generated	= 250 ps

$$GDP = \sum(\text{Rent + Wages + Interest + Profit}) = 2.5 \text{ Rs}$$

Value addition by bakery = value of output (₹ 2) minus value of inputs (₹ 1.5) = ₹ 0.5

Then McDonalds sells this cake to Virat Kohli for ₹ 2.5, who then eats it very happily.

Value addition by McDonalds = value of output (₹ 2.5) minus value of inputs (₹ 2) = ₹ 0.5

Total value addition in this whole process is 1 + 0.5 + 0.5 + 0.5 = ₹ 2.5

Concept and Measurement of "Value Added"

It is defined as the difference between the value of output of a firm and value of inputs bought from other firms. It is thus the value which the firm concerned has added by its process of production (Value addition is not the profit. Rather profit is just a part of value addition). Most goods pass through many stages of production.

The value of the final good is equal to the sum of the value added at each stage of production.

Sum of value added = 1 + 0.5 + 0.5 + 0.5 = 2.5

= Value of the Final Good

GDP contribution = 2.5 (1 + .5 + .5 + .5) GDP is sum of value addition at each stage of production and not 1 + 0.5 + 2 + 2.5 = 7

It will not be the sum total of values of outputs at each stage. We won't add the value of the intermediate goods in the GDP but we will add the value addition at each stage. If we add the value of intermediate goods, we will be counting the value of one good many times (also called double counting of goods).

Income Approach

Here GDP is sum of all factor incomes generated in the production of a good.

It includes:

1. Wages
2. Profit to the owners of the firm
3. Rent earned by owners of the land
4. Interest earned by the person providing capital

In the above example, while producing wheat, flour, cake and giving services at Mc.Donalds, factor incomes are generated at each stage e.g. the miller purchases the wheat at ₹ 1, converts it into flour and sells it for ₹ 1.5. But for doing it, he needs a piece of land, for which he pays a rent (10 paise), he employs a labourer and he gives wages (15 paise) to him, he has taken a loan from a bank, for which he has to give interest (10 paise) and then whatever is left after paying rent, interest and wages, he gets it as his profit (15 paise). All this is repeated at every stage. So when we add factor incomes generated at each stage, we get GDP by Income Approach.

Expenditure Approach

Here GDP is considered as the sum of Expenditure. There are three different types of expenditures:

1. **Private final consumption expenditure (PFCE/C(1)):** It is the monetary value of goods & services purchased by households or individuals or nonprofit institutions like gurudwaras during a time period. It is divided in 3 subcategories:

   Consumer services e.g. Banking, transport, education, etc.

   Consumer non-durable goods e.g. Food, Clothes, etc. These goods are used in a very short span of time.

   Consumer durable goods e.g. Fridge, TV, etc. They are used for a longer period of time. Private consumption expenditure adds up the expenditure of all the 3 categories above.

2. **Investment (I):** It includes four categories:
   - **(a) Business fixed investment:** Amount spent by business units on purchase of new machinery.
   - **(b) Inventory Investment (also called change in stock):** It includes all those goods which have been purchased but not yet sold. These must be included since they represent currently produced output but are not included in the current sale of final output. The difference between goods produced and goods sold in a year is called inventory.
   - **(c) Residential construction investment:** Amount spent on building housing units.
   - **(d) Public investment:** It includes all capital formation carried by the government for the construction of roads hospitals, etc. Total investment will be sum total of all the above investment.

   Total investment is also called Gross Capital Formation. It also includes expenditure on valuables like gold and silver. Expenditure on machinery, infrastructure (by public and private both), land improvements and residential construction comprises Gross Fixed Capital Formation (GFCF).

3. **Government purchase of goods & services (G):** It includes the government spending on goods & services. e.g. salaries. At the same time the government makes payments to certain categories of people to compensate them. E.g. Pensions, scholarships, etc. food coupons, direct benefit transfers. They are called transfer payments or Government transfer Payments. They aren't counted in the GDP because there is no production of goods or services. Money is just getting transferred from the government account to the beneficiary account.

4. **Net Exports = Exports (X) – Imports (M)**

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

ICOR (Incremental Capital Output Ratio)

ICOR is defined as incremental / additional capital required to produce one additional unit of output. ICOR is how much extra unit of capital is required to produce one additional unit of output. It represents how efficiently capital is being used in a country to produce output.

$$ICOR = \frac{\text{Change in capital}}{\text{Change in output}}$$

If ICOR of India is 4, that means India requires ₹ 4 of capital goods to produce ₹ 1 of additional output.

The higher the ICOR, the lower is the productivity of capital. Thus, a high ICOR can be considered as a measure of the inefficiency with which capital is used. In India, ICOR is little above 4.

ICOR is influenced by a number of factors such as technology, skill of the labour force, which in turn depends on the quality of the education system and ease of doing business. Bureaucratic hurdles, which impede speedy execution of projects need to be removed. Thus improving the productivity of capital requires steps at several fronts.

Economic growth depends on investment rate and ICOR.

In other words,

Economic Growth = Investment rate / ICOR

If investment rate is 36% and ICOR is 4, then economic growth = 36%/4 = 9%. But if we decrease the ICOR to 3, then with the same investment, we will get an economic growth of 12%. During the credit boom time (2003- 2008) in India, Investment rate was around 36% and ICOR was 4.4, so we were growing at around 8%.

But in the present, the ICOR has increased due to the struck projects and twin balance sheet problem and investment has also decreased to around 27%.So the growth rate has come down and currently we are growing at around 4.2% (2019-20).

Growth, Boom, Slowdown and Recession

Suppose the following figures represent GDP numbers over a period of consecutive years :

Growth

100 → 105 → 112 → 121 → 135

(Here 100,105, etc. are considered as GDP) Economic Growth or just growth is increase in GDP over a period of time

Boom

100 → 110 → 125 → 150 → 250

i.e. increase in GDP by leaps and bounds .

As such there is no technical definition of boom. Generally, a very high growth in the Economy is considered as a Boom.

Slowdown

100 → 110 → 118 → 120 → 121 i.e. increase in GDP but at a decreasing rate

Recession

100 → 95 → 85 i.e. fall in GDP.

Technically speaking, recession is fall in GDP over two consecutive quarters.

*In Economy all comparisons are made with the previous year. GDP growth will be measured by comparing GDP of this year with the GDP of previous year. Quarterly GDP growth is calculated by comparing GDP of a particular quarter with the same quarter of the previous year. E.g. if GDP growth of Q4 2019-20 is 3.1%, it means GDP of Q4 of 2019-20 is 3.1% more than GDP of Q4 2018-19.

GDP is calculated quarterly and the result comes with a two month lag period. So data for Q1(April-June) Financial year 2020-21 will come out by august end. (quarter ends on 30th June and then a two month lag period). On the other hand, inflation is calculated monthly. To calculate inflation, prices of a particular month will be compared with the prices of the same month of the previous year. E.g. if inflation is 5% for June 2019, it means prices were overall 5% more in June 2019 as compared to June 2018. Inflation data comes out with 2 weeks lag period. So inflation data for the June month will come by 14th July.

Suppose the following represent prices of the January month over consecutive years :

Inflation

100 → 105 → 112 → 121 → 135

i.e. increase in prices over a period of time

Hyperinflation

100 → 110 → 125 → 150 → 250

i.e. increase in prices by leaps and bounds

Disinflation

100 → 110 → 118 → 120 → 121

i.e. increase in prices but at a decreasing rate

Deflation

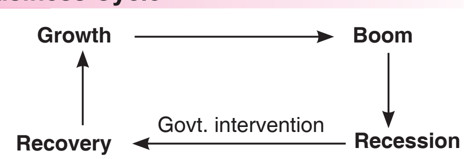
100 → 95 → 85 → 80 → 75 i.e. fall in prices

Reflation

100 → 90 → 80 → 90 → 100

i.e. bringing the inflation back in the positive range. Here moving from 80 to 90 and from 90 to 100 is reflation.

Business Cycle



An economy moves from growth to boom then to recession then to recovery and then back to growth. This is called a business or economic cycle. It is not necessary that an economy will surely have a boom or will surely have a recession. It's quite possible that an economy goes from growth to recession and then to recovery and then to growth again. And it is also possible that there is no recession or no boom at all. The economy may move from growth to slowdown and then back to growth. But what is sure that the economy will not always go up or will not always come down. There will always be ups and down in the economy.

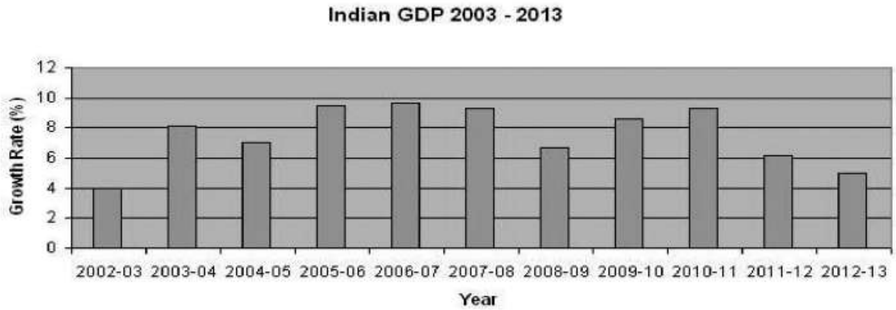


Fig. 1.1

It moves from growth to boom and then to recession itself. i.e. with help of market forces of supply and demand. But it cannot move out of recession itself. Here there will be a requirement of active intervention by the government in the form of a stimulus package.

A stimulus package is an attempt by the policymakers to kickstart a sluggish economy through a package of measures. A monetary stimulus will see the central bank expanding money supply (liquidity) or reducing interest rates to encourage consumer spending. A fiscal stimulus (also called expansionary Fiscal Policy) is one in which the government spends more especially on infrastructure creation, will also provide more subsidies, slashes tax rates or gives loan waivers.

Stimulus package puts more money in the hands of consumers and spending goes up, thereby encouraging demand & growth.

Stimulus Package 2008

After the 2008 Subprime crisis India, like many other countries provided a fiscal stimulus package. It included excise duty cuts, infrastructure financing, government employee pay revision and big ticket government purchases.

Consequently, growth revived from 6.7% in FY09 to 8.9% in FY11. But at the same time, fiscal deficit (will be discussed in fiscal policy chapter) of the government for FY09 rose to nearly 8% of GDP, from the projected 2.5%. (Reference: The Hindu)

The stimulus package (Atma Nirbhar Bharat) given to the economy to counter the effect of covid19 has been discussed in the Fiscal Policy Chapter.

GNP (Gross National Product)

It is the value of output produced by the nationals of a country both within the geographical boundary and outside. Income is calculated as part of GNP on the basis of who owns the factors of production rather than where the production takes place.

The difference between GDP and GNP is that GNP includes net factor income from abroad. Therefore, if we have to get GDP from GNP, we should subtract net factor income from abroad (NFIA) from GNP. Or to calculate GNP, we add the income of Indians from abroad and subtract the contribution of foreigners in India's GDP.

GNP = GDP + (Factor income earned by the domestic factors of production employed in the rest of the world) minus (Factor income earned by the factors of production of the rest of the world employed in the domestic economy.

$$\boxed{\text{GNP} = \text{GDP} + \text{NFIA}}$$

(NFIA stands for Net Factor Income from Abroad).

The items counted in NFIA are

1. **Interest of external loans:** India takes more loans than it provides to other countries. Therefore, India pays more interest on external loans as compared to the interest what it earns on the loans given to other countries. So, the interest is overall negative in India's case. Net interest = interest earned – interest paid = –ve (India pays more interest)
2. **Profit from entrepreneurship and returns on investments (FDIs/FPIs) like dividends and interest:** Negative in case of India. There are more foreign companies investing in India as compared to Indian companies investing abroad. Moreover, the amount invested by foreign companies is greater compared to what Indian companies invest abroad. Therefore, the returns on investments of foreign companies is larger. Net income is equal to Indian companies getting return on investment from abroad minus foreign companies getting return on investment made in India. It is negative for India (net outflow of profits and other returns)

3. **Private remittances:** It is that net outcome (result) of money which inflows and outflows on account of private transfers by Indians working outside (sending money to India) and foreign nationals working in India (sending money to their homeland). In India's case, it is positive due to large remittances (India is the largest receiver of remittances in the world) sent by Indians especially from the Gulf region, US, EU, etc.

   In India, the balance of above three points comes out to be negative and hence NFIA in India is negative.

   GNP = GDP + NFIA

   GNP (India) = GDP(India) – NFIA

   GDP (India) > GNP(India)

   GNP is the national income according to which IMF ranks the nations of the world.

Net Investment, Depreciation, Net Domestic Product (NDP)

That part of the final output which comprises physical capital goods is called gross investment. So, investment is not measured as money put in business or any economic activity but it is basically that portion of the final output which consists of capital goods. Suppose there is only one factory in a country which is worth of 1 lakh and is producing consumption goods worth of 700 rupees and capital goods worth of 300 rupees in a particular year. This means the GDP will be ₹ 1000 (which is total production of both consumption and capital goods) and gross investment in the economy will be ₹ 300 or (₹ 300 / ₹ 1000) 30%, as investment is measured as the percentage of output which consists of capital goods.

If the country imports capital goods worth of ₹ 100, then the gross investment will be ₹ 300 + ₹ 100 i.e. ₹ 400 and investment %age will be ₹ 400 / ₹ 1000 or 40%.This is because ₹ 100 worth of capital goods is added in the economy. But if we also export capital goods worth of ₹ 40, then gross investment will be (₹ 300 + ₹ 100 – ₹ 40) i.e. ₹ 360 and investment percentage will be 36%. Investment in the economy is also called Gross Fixed Capital Formation.

Now, when the factory runs for a year, then wear and tear happens in the factory which is called depreciation. Depreciation is also defined as consumption of physical capital. In the above example, rupees 1 lakh worth of capital goods produce ₹ 700 worth consumption goods and ₹ 300 capital goods. But during this production process suppose there is wear and tear of ₹ 50 in the factory. This implies that to produce ₹ 700 of consumption goods and ₹ 300 of capital goods there is a loss of ₹ 50 of capital goods in the economy i.e. net production of capital goods (investment) in the economy is ₹ 300 minus ₹ 50.

Net Investment

= Gross Investment – Depreciation

= ₹ 300 – ₹ 50 = ₹ 250

Net Domestic Product (NDP)

= GDP – Depreciation

= ₹ 1000 - ₹ 50 = ₹ 950

Let us understand depreciation with another example. Suppose, I bought a car in 2005 for ₹ 10 lakhs. It would go up to 2015. (life time 10 years). I included ₹ 10 lakh in 2005's GDP. Each year I am subtracting ₹ 1 lakh from the GDP. By the end of 10 years, the GDP would be balanced in expenditure.

Unlike intermediate goods, which are consumed entirely in the process of making final goods, the capital goods are only partially depleted in making final goods. If a steel mill may have a useful life of 50 years, then in providing steel in one year, only a small portion ($1/50^{th}$) of the mill is used. This using up of capital is called Depreciation.

Depreciation is the value of the existing capital stock that has been consumed in the process of producing output. The inclusion of capital goods (steel mill or cars) in the final product along with the goods (steel and services, taxi services) produced by them would involve double counting. Therefore it is important to make provision for depreciation. If every year we deduct from investment (hence from the domestic product) the amount by which the capital stock has been used up over the years, then over the whole life span of the capital good we'd have deducted from the domestic product the whole value of the capital good.

In this way, we will avoid counting in the domestic product both the asset and goods & services produced by and so shall have avoided double counting.

NDP = GDP – Depreciation

NNP = GNP – Depreciation

GDP at Market Price and GDP at Factor Cost

Market price refers to the actual transacted price and it includes indirect taxes like excise duty and custom duty. Factor cost is the actual production cost at which goods and services are produced by an industry in an economy. They are really the cost of all the factors of production (Land, Labour, Capital, Entrepreneur).

Market price = factor cost + indirect taxes – subsidies

Net Indirect Taxes = Indirect taxes – subsidies

@ M.P means at market prices @ F.C means at factor cost

GDP @M.P = GDP@F.C + indirect taxes – subsidies

GDP @M.P = GDP @F.C + Net Indirect Taxes

Nominal GDP and Real GDP

If the GDP or any other related aggregates is measured in terms of **current market prices,** then it is called **nominal GDP.**

Nominal GDP includes the influence of inflation on the prices. Nominal GDP will change when either the overall price level changes or when actual volume of production changes or when both change simultaneously.

Real GDP is calculated at **constant prices** i.e. prices of the base year. In this method, the GDP value is expressed in terms of prices prevailing in a year chosen to be a base year. In the given example, 2015 is taken as the base year and prices of 2015 are called base prices or constant prices.

2015

5 fans × ₹ 100 = ₹ 500

inflation

2016

Case I

6 fans × ₹ 120 = ₹ 720 **Nominal GDP**

Current price

Case 2

5 fans × ₹ 120 = ₹ 600 **Nominal GDP**

Current price

Case 3

6 fans × ₹ 100 = ₹ 600 **Real GDP**

Constant price

2017

Case 1

7 fans × ₹ 140 = ₹ 980 **Nominal GDP**

Current price

Case 2

7 fans × ₹ 100 = ₹ 700 **Real GDP**

Constant price

Base year is chosen as the year where there isn't much fluctuation in internal & external level.

When final goods and services included in GDP are valued at current market prices, i.e., prices prevailing in the year for which GDP is being measured, it is called GDP at current market prices or Nominal GDP, For example. Nominal GDP of 2020-21 is the value of output produced in 2020-21 at the market prices that prevail in 2020-21.

On the other hand, when goods and services included in GDP are valued at constant [fixed) prices, i.e. prices of the base year, it is called GDP at constant prices or Real GNP. For example, real GDP of 2020-21 is the value of output produced in 2020-21 measured at base year's (currently base year for GDP calculation is 2011-12) prices. Constant prices refer to prices prevailing in some carefully chosen year called base year. Mind, a base year is a normal year devoid of price fluctuations.

National Income = Real NNP@ market price

We can have aggregates like Real GDP @ F.C, Real GDP @ M.P, Nominal GDP @ F.C and Nominal GDP @ M.P. Suppose for the base year 2011-12, only 1 fan is produced and its factor cost is 100 rupees. Net Indirect taxes for 2011-12 is ₹ 10.

Now in 2020-21, suppose 7 fans are produced and the factor cost of each fan has increased to ₹ 700 (due to inflation) and net indirect taxes collected in the year 2020-21 is 80 rupees.

Then, for the year 2020-21;

Real GDP @ F.C = 7 x 100 = 700 (GDP calculated at base prices without adding any taxes) Real GDP @M.P = 7 x 100 + 80 = 780 (GDP calculated at base prices but adding indirect taxes of the year 2017-18)

Nominal GDP @ FC = 7 x 700 = 4900(GDP calculated at current prices but without adding any taxes)

Nominal GDP @ M.P = 7 × 700 + 80 = 4980(GDP calculated at current years prices and also adding current years collection of net indirect taxes)

So, Real GDP @F.C will increase as compared to previous year only when production increases.

Real GDP @M.P increases compared to previous year if either the production increases or if current year's net indirect tax collection is more as compared to previous year.

Nominal GDP @ F.C will increase as compared to previous year when production increases or when the prices increase.

Nominal GDP @ M.P increases as compared to previous year when production increases or when the prices increase or when current year's net indirect tax collection is more as compared to previous year.

India's Nominal GDP at @M.P. for 2019-20 was approx. ₹ 204 lakh crores and Real GDP @M.P. was around ₹150 lakh crores (Reference: Economic Survey 2019-20)

GDP Deflator

It is a comprehensive measure of inflation. It is implicitly derived from National accounts data as the ratio of nominal GDP to real GDP.

Its positive side is that it isn't limited to basket goods as in WPI (wholesale price index) or CPI (Consumer price index) (explained in the Inflation chapter) but encompasses all the goods produced in the country.

But its negative aspect is that it is available on an annual/ quarterly basis, while WPI or CPI based inflation data comes out monthly.

$$\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

E.g. A price deflator of 200 means that the current year price is twice its base year's price.

Per Capita Income

It measures the average income earned per person in a given country in a specified year. It is calculated by dividing the country's total income by its total population.

India's per capita income for 2019-20 was ₹ 11,254 per month. (Reference : Economic Survey 2019-20)

National Income : Current Updates

CSO in January 2015, released the new and revised data of National Accounts, effecting two changes:

The Base Year was revised from 2004-05 to 2011-12

The methodology of calculating the national Accounts has also been revised in line with the requirements of the System of National Accounts (SNA)-2008, an internationally accepted standard.

New Method of GDP Calculation (CSO 2015 reforms)

The UN, WB, IMF, OECD (Organisation of economically developed countries) and European Commission have collaborated to give the **System of National accounts (SNA)** and have advised the countries to keep their national accounts in this format. In this method, we calculate GVA and then GDP.

Earlier in income method :

Total income = Wages + Profit + Rent + Interest

But under the new method, we will add, compensation to employees + Mixed income / operating surplus (earlier profit) + consumption of fixed capital

Compensation to Employees

It includes wages plus any social security benefit given by the employer like Provident fund contribution or insurance premium paid by the employer.

Operating Surplus/Mixed Income

Operating surplus or mixed income is a measure of the surplus accruing from processes of production before deducting any explicit or implicit interest charges, rent or other property incomes payable on the financial assets, land or other natural resources required to carry on the production. The surplus so arrived in the case of incorporated enterprises is called operating surplus. The surplus arrived in the case of unincorporated enterprises is called mixed income.

Incorporated enterprises refer to enterprises that are established as a separate legal entity. A separate legal entity is an entity which can be treated like a human being. It is capable of entering into contracts and on failure of its contract it can be sued in a court. e.g. Companies and Limited Liability Partnerships (LLPs) registered under the Companies Act. If the legal entity is not able to repay the borrowed loan, the investors or promoters of the legal entity is not responsible to repay the loan availed by the company. E.g. For the default of Kingfisher Airlines Ltd., Vijay Malaya cannot be held responsible unless it is proved that Vijay Malaya misused his position and misappropriated the borrowed funds. Unincorporated enterprises are enterprises that are not incorporated as separate legal entities. There is no distinction between the owners/investors and the entities. e.g. Proprietorship concerns, partnership concerns. The proprietorship concerns cannot enter into any contract. They cannot borrow. Everything should be done in the name and by the owner/investor.

The unincorporated enterprises are owned by households in which the owner(s) or members of the same household may contribute unpaid labour inputs of a similar kind to those that could be provided by paid employees. The households do not charge separately for the labour contributed by them for their own enterprises. They take the entire surplus. The surplus is described as mixed income because it implicitly contains an element of remuneration for work done by the owner, or other members of the household, that cannot be separately identified from the return to the owner as entrepreneur.

Only workers and labourers get wages and entrepreneurs get profit but what about the not registered, non-organised agro and cottage industry.

How will we decide how much has come from wages and how much Money has come from profit? For all those companies which don't distinguish between wages and profit, the concept of mixed income will be used. For companies which follow standard accounting, operating surplus would be used.

Consumption of Fixed Capital

It is the decline in the current value of the stock of fixed assets owned and used by a producer as a result of physical deterioration. The plant and machinery fall under the category of capital assets. It undergoes wear and tear in the manufacturing process. It is a sort of depreciation. It is called consumption of fixed capital.

GVA @F.C = Compensation to employees + Consumption of fixed capital + (Mixed Income/Operating Surplus)

GVA@basic price = GVA @F.C + production taxes – production subsidies

Production Tax and Production Subsidies

They are paid to the government or received by the people or firms with relation to production and are independent of volume of actual production.

Production taxes are given even if the products are not produced. e.g. of production taxes are stamp duty, land revenue, registration fees, professional tax, etc.

Production subsidies include subsidies on irrigation, free electricity to farmers, etc.

GDP = GVA @basic price + Product tax – Product subsidy

GDP = GVA @ F.C + production taxes + product taxes – production subsidies – product subsidies

This is same as GDP @M.P.

Product Taxes

They are dependent on volume of production. e.g. excise tax, VAT.

Product Subsidies

They are dependent on volume of production. e.g. food subsidy, petroleum subsidy.

India's current GDP is Real GDP @M.P. and GDP before 2015 reforms; it was Real GDP @F.C.

Growth rates are critical for internal policy making as it has a bearing on both monetary and fiscal policies. E.g. If we overestimate the growth rates, we might keep interest rates too high from a cyclical perspective, which might prolong growth stagnation. The issue of data unreliability must be seriously addressed in a modern economy that is increasingly data dependent.

Terms excluded from GDP measurement

1. Purely Financial Transactions

These are of 3 types:

(a) **Buying and selling of securities:** In financial markets, people buy and sell financial assets such as shares. When someone buys a share from another person, there's only transfer of ownership. There is no production activity but only exchange of funds. Hence the value of shares and bonds is not included in GDP. But the interest earned on bonds and dividend on shares is included in GDP.

(b) **Government transfer payments pensions, scholarships, ad-hoc assistance in calamities** like floods, subsidies given directly to the beneficiary are not added in GDP as there is no production of any good or service. There is only transfer of funds from the government's account into the beneficiary's account. These payments are called government transfer payments.

(c) **Private transfer payments:**

E.g. Pocket money.

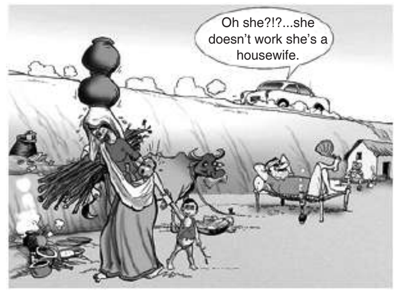
2. **Selling of used goods:**

Price of second hand goods is not included in GDP as their price has already been included at time of the first sale and adding their price in GDP would result in double counting.

3. **Non Market goods and services**

Many final goods and services are not acquired through regular market transactions. E.g. Vegetables grown in personal gardens instead of being bought from supermarkets or electrical faults repaired by the house owner himself instead of an electrician.

GDP includes only those transactions that occur through market mechanisms



Barter transactions or production for self-consumption of households aren't included in GDP. Value of work done by housewives isn't included in GDP.

4. **Illegal activities**

GNP doesn't include trade in illegal services. Even though they are final goods and are purchased in market transactions. E.g. Smuggling, Gambling, etc. These illegal activities create an underground economy or parallel economy wherein production is unreported or unaccounted because either it is unlawful or those who are involved want to evade the tax net. As a result these illegal and hidden transactions create a huge volume of unaccounted money called Black Money.

5. **Environmental cost**

GDP estimation doesn't account for environmental loss incurred in production of goods and services.

E.g. River water degradation due to discharge of chemical waste.

Limitations of GDP as a measure of welfare

It doesn't value intangibles like leisure, quality of life, etc.

Impact of growth can be harmful for the environment. It can also cause lifestyle diseases. E.g. Obesity

- It only gives average figures that causes stratification (it makes layers). Economic inequality is not revealed by GNP figure.
- Condition of poor is not indicated. Doesn't show gender disparity.
- Doesn't measure sustainability of growth.

Green GNP

GNP (or GDP) does not take into consideration the cost in terms of (i) environmental pollution and (ii) depletion of natural resources caused by production of output. Mere increase in GNP will not reflect improvement in quality of life if it increases environmental pollution or reduces available resources for future generations. That is why the concept of Green GNP has been introduced.

Green GNP is defined as "GDP which is an indicator of a sustainable use of the natural environment and equitable distribution of benefits of development."

This concept denotes the following characteristics, (i) Sustainable economic development, i.e., development which should not cause environmental degradation (pollution) and depletion of resources, (ii) Equitable distribution of benefits of development, (iii) Promote economic welfare for a long period of time.

Purchasing Power Parity

Purchasing Power parity is defined as the number of units of a country's currency required to buy the same basket of goods and services in the domestic market as one dollar would buy in the US.

PPP is an attempt to work out how much currency will be needed to buy the same basket of goods and services in different countries. It reflects the underlying exchange rate between the two different countries for buying goods and services, and a more.

Suppose, India's GDP is ₹ 1000 and market exchange rate is 1$ = ₹ 50. Then in dollar terms, India's GDP is 1000/50 = 20$.

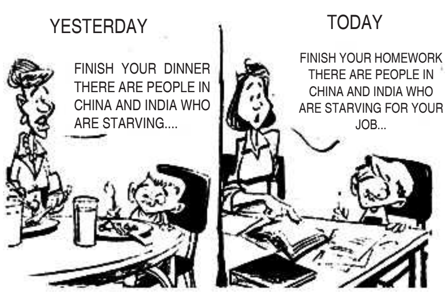
Now suppose, price of 1 apple in USA is 1$ i.e. 1 Apple = 1$

And the price of the same apple (basket of goods) in India is ₹ 25. i.e 1 Apple = ₹ 25.

So 1$ buys the same amount of goods in the USA as ₹ 25 in India, We can say that purchasing power of 1$ is equal to purchasing power of 25 rupees. i.e. 1$ = 25 rupees.

So if we calculate GDP of India at purchasing power parity (parity means equality), it is 1000/25 = 40$.

GDP of every country is measured using market exchange rate and purchasing power exchange rate, where it is called GDP at PPP (purchasing power parity). The PPP exchange rates help to minimize misleading international comparisons that can arise with the use of market exchange rates.



IMF's Classification of Countries

The World Economic Outlook (WEO,IMF) classifies the world into **two major groups:**

(a) Advanced economies

(b) Emerging market and developing economies

The above classification is based on **three parameters:**

1. PCI (Per capita income) using PPP exchange rate
2. Export diversification
3. Degree of integration into the global financial system

Least Developed Countries, Developing Countries, and Developed Countries

The Least Developed Countries (LDCs) are countries that, according to the United Nations, exhibit the lowest indicators of socio-economic development, with the lowest human development index (HDI) ratings of all the countries in the world. The concept of LDCs originated in the late 1960s. A country is classified among the LDCs if it meets three criteria:

1. **Poverty:** As of 2015, a country must have GNI per capita less than $1035 to be included on the list and over $1242 to graduate from it.
2. **Human resource weakness** (based on the indicators of nutrition, health, education, and adult literacy).
3. **Economic vulnerability** (based on the instability of agricultural production, instability of exports of goods and services, merchandise export concentration, and the percentage of population displaced by natural disasters).

The LDC criteria is reviewed every 3 years by the Committee for Development Policy (CDP) of the UN Economic and Social Council (ECOSOC). Countries may graduate out of the LDC classification when indicators exceed these criteria.

A **Developing Country**, also called a **less developed country or an underdeveloped country** is a nation or a sovereign state with a less developed industrial base and a low HDI relative to other countries. There are no universally agreed criteria that makes a country developing or developed, although there are general reference points such as a nation's GDP per capita compared to other nations. Less developed country is a general term and should not be confused with the specific term, least developed country. The definition of least developed country is given by the United Nations.

A **Developed Country, industrialized country, or 'more economically developed country (MEDC)**, is a sovereign state that has a highly developed economy and advanced technological infrastructure relative to other less industrialized nations.

Most commonly, the criteria for evaluating the degree of economic development are GDP, per capita income, level of industrialization, amount of widespread infrastructure, and general standard of living. **Criteria** are to be applied, but which countries can be classified as being developed are subjects of debate. Developed countries have post industrial economies, meaning the service sector provides more wealth than the industrial sector.

Middle Income Trap

World Bank has used the 2018 data of gross national income **(GNI) per capita** to categorize countries into following four categories

1. **Low income:** Countries with GNI per capita is up to $1,025
2. **Lower middle-income:** Those with GNI per capita from $1,026 to $3,995. Ex: **India –** its per capita income in 2018 was $2,020, at the halfway point for the lower middle-income category.
3. **Upper middle-income:** Countries with GNI Per capita between $3,995 and $12,376 are upper middle income Ex: **Brazil, South Africa, Mexico, China, etc.**
4. **High income:** Per capita income above $12,376 makes a country high income. Ex: US, Germany, Japan, Korea.

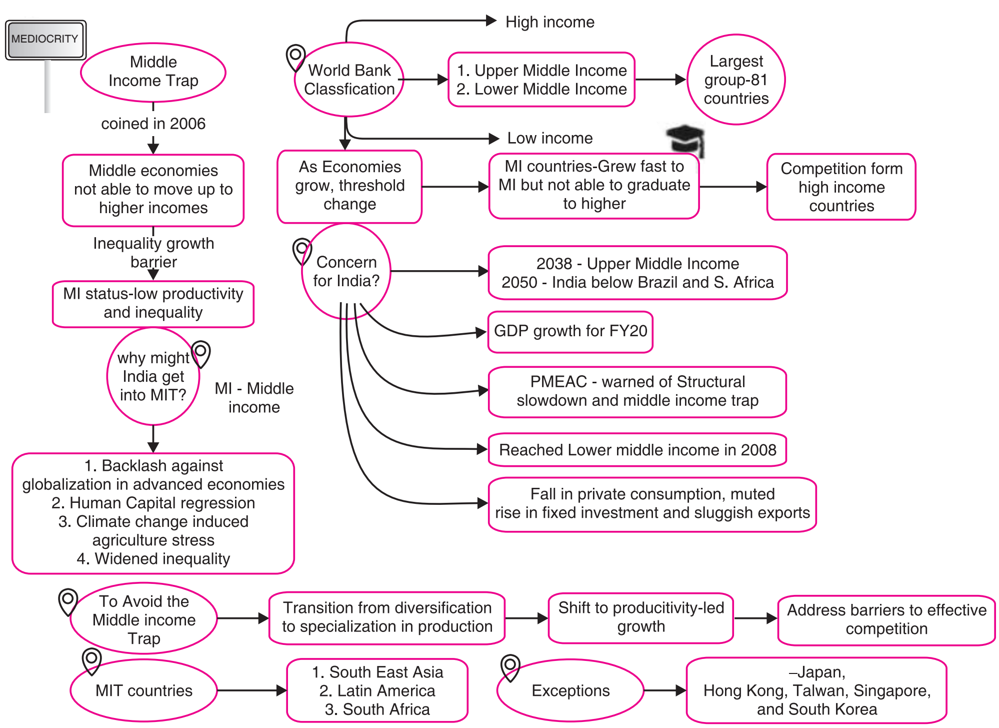
The way the World Bank's income classification system works is that as economies grow, the thresholds for these four categories also change. The threshold for the low-income category in 1988 was only $545.

Middle Income Group is the largest with around 81 countries in this group. In **2006**, economists **Indermit Gill** and **Homi Kharas** at the World Bank coined the term "middle-income trap" while working on growth strategies for East Asian economies. MIT is a relatively new phenomenon and was first mentioned in 2007 in the World Bank report.

Middle Income Trap is a situation for Middle Income Countries where they are not able to move up to the higher income status due to several adverse factors. The "middle-income trap" is the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels (of per capita income) and failing to graduate into the ranks of high-income countries.

The term middle-income trap (MIT) usually refers to countries that have experienced rapid growth and thus quickly reached middle-income status but then failed to overcome that income range to further catch up to the developed countries and achieve high-income status.

The countries caught in the Middle Income Trap are unable to compete with low-income, low-wage economies in manufactured exports and unable to compete with advanced economies in high-skill innovations.



Mind Map 1.2

Many countries, particularly in South East Asia (e.g. Thailand, Vietnam, and Malaysia, etc.), Africa (e.g. South Africa) and Latin America (e.g. Brazil) currently face the predicament of MIT.

One of the most standard examples of an MIT country is Brazil where annual income growth rate plummeted to an average rate of 0.58% between 1997 and 2011. It was accompanied by one of the highest income inequalities worldwide.

Simply put, low-income countries with cheap labour and access to ready-made technology grow fast and start becoming wealthier. However, as they reach middle-income status, they tend to slow down as they lose some of their advantages. They fail to converge with wealthier nations and do not get beyond middle-income status. It is a **status of low productivity** and inequality.

Wealth inequality and the hierarchical distribution of income in developing countries have long been identified as a growth barrier. The greater the gaps between strata, the slower the upward mobility of families that are at lower levels.

Such economies typically experience lopsided expansion, with the positive fallout of growth on top often failing to reach those below.

To sustain growth for longer periods, there is a need of mass mobilization of financial as well as human resources. But this doesn't happen if there is acute inequality.

If a country cannot make a timely transition from resource-driven growth, with low-cost labour and capital, to productivity-driven growth, it might find itself trapped in the middle income zone.

Traditional exports cannot be as easily expanded as before because wages are higher and cost competitiveness declines.

Many middle-income countries in Latin America have been through cycles of growth based on credit extended during commodity booms, followed by crisis, and then recovery. This **stop–go cycle** has prevented them from becoming advanced economies despite enjoying many periods of fast growth. This is in sharp contrast with successful countries in East Asia—Japan, Hong Kong, Taiwan, Singapore, and South Korea that have been able to sustain high growth over some 50 years.

Cause of Concern for India

1. If we assume that World Bank thresholds and India's income per capita grow at the same pace as they have in the past 30 years, it will take India until 2038 to reach the lower end of the upper middle-income threshold. Likewise statistics reveal that even in 2050, India would be well below Brazil and South Africa.
2. **GDP growth for FY20** is likely to come in at 5%, an 11-year low (After Covid issues, it is 1.7%). Nominal GDP growth will likely be at more than a four-decade low. Recently, a member of the PM Economic Advisory Council (PMEAC) warned that India may be nearing a structural slowdown and may soon get caught in the 'middle income trap' like Brazil and South Africa.
3. Fall in private consumption, muted rise in fixed investment and sluggish exports have led to slowdown in the economy. Apart from the debate on whether the slowdown is cyclical or structural, there is also concern among economists about the dangers of the Middle-Income trap in medium to long term

In **1960**, India was a low-income country with per capita income around 6% of the US. However, India attained the status of lower middle income in 2008 with per capita income of about 12% of the US. But, the growth has occurred with limited transfer of labour resources to high productivity and dynamic sectors, despite relatively modest agricultural growth. Thus, the risk of getting trapped in the middle income zone remains.

Why might India get caught into the middle income trap?

- **Backlash against globalization:** Hyperglobalization (that benefited the early convergers like China, South Korea & Japan) led to a backlash in the advanced countries, as seen through increasing protectionism & lowering World Trade-GDP ratios since 2011. This means that similar trading opportunities may no longer be available for the new convergers.
- **Human capital eregression:** The new advances in technology not only require skilled human capital, but also demand them to learn continually. As opposed to these requirements, there is a wider educational attainment gap between lower income countries and advanced economies.
- **Climate change-induced agricultural stress:** With climate change, ambient temperature has increased and weather extremities have become a recurrent phenomenon. This is, in particular, a threat to India where agriculture is heavily dependent on precipitation.

  India's growth since the 1990s was on the back of consumption by the top 100 million Indians. The inequality has widened since then and therefore, the future growth has to come from bottom sections of the societal pyramid. For this to happen there has to be adequate demand from these sections of society & thus adequate jobs and rising incomes.

Avoiding the Middle Income Trap

To avoid becoming trapped without a viable high-growth strategy, India needs to:

- **Transitioning from diversification to specialization in production:** Specialization allowed the middle-income Asian countries to reap economies of scale and offset the cost of disadvantages associated with higher wages (E.g. Electronics industry in South Korea). High levels of investment in new technologies and innovation-conducive policies are two main requirements to ensure specialized production. Developing good social safety nets and skill-retraining programs can ease the restructuring process that accompanies specialization.

- **Shifting to productivity-led growth:** Total factor-productivity growth in middle-income countries requires major changes in education, from primary & secondary schooling to tertiary education so that workers are adept in new skills as per the demands of the markets. Creating such a knowledge economy requires long term planning and investment.
- **Addressing barriers to effective competition:** There is a need to address rigidities that can arise from bankruptcy laws, stringent tax regulations, limited enforcement of IP regulations, imperfect information, discrimination, etc.

  There has to be a comprehensive agenda of policy and institutional change to create a dynamic capitalism, else there is a risk of a Latin Americanization of India's path. This involves changes in education, healthcare, skilling, agricultural, judicial and regulatory reforms. By accelerating structural changes and fastening industrialization, India should raise the per capita income in future so that it can attain a per capita income of upper middle income and later to higher income to escape from the trap.

Merger of NSSO and CSO

The government has decided to merge the Central Statistical Organisation (CSO) and the National Sample Survey Office (NSSO) **to form a National Statistical Office (NSO),** under the Ministry of Statistics and Program Implementation (MOSPI).

The move is a follow-up of a decision taken by the government in 2005, based on recommendations of the report of the **National Statistical Commission,** headed by C Rangarajan.

Both CSO and NSSO are currently part of the **Ministry of Statistics and Programme Implementation (MoSPI)** and functioning independently.

The **CSO** brings out macro economic data like economic (GDP) growth data, industrial production and inflation. It has a well-equipped Graphical Unit. The CSO is located in Delhi.

The **NSSO** was set up in 1950 to conduct large-scale sample surveys throughout India. It brings out reports on health, education, household expenditure and other social and economic indicators.

The employees of the NSSO are from the Indian Statistical Service (appointed through UPSC).

The restructuring is in line with the proposed **National Policy on Official Statistics.** The proposed National Statistical Office would be **directly under the government** headed by the secretary of the MoSPI.

5 Trillion Economy Target

The PM has set an economic target of $5 trillion by 2024 for Indian Economy. Currently, it is $2.7 trillion and India is the fifth-largest economy in the world. The target implies an output expansion by 84% in five years, or at 13% compound annual growth rate. The required growth rate in real GDP should be 9% per year. In the last five years India officially grew at 7.1% only. Thus the target is an ambitious one.

Efforts required

In the last five years, on an average, the domestic saving rate was 30.8% of GDP, and the investment rate was 32.5% of GDP.

India will have to turn into an **investment-led economy** as it happened during the boom last decade (2003-08) before the financial crisis, or like China since the 1980s.

India has a low domestic savings rate. India requires nearly 8-9 percentage point boost to saving and investment rates.

In order to accelerate its growth rate, India would require an increase in the domestic saving rate to close to 40% of GDP. Which means **investment in the economy should be based on domestic resources.**

FDI can fulfil important gaps in investment. However, it cannot be a substitute for domestic resources as has been witnessed in the Chinese growth story.

Challenges

The domestic saving rate has declined from 31.4% in 2013-14 to 29.6% in 2016-17; and gross capital formation (Investment) rate from 33.8% to 30.6% during the same period.

The banking sector's ability to boost credit growth is limited by non-performing assets (NPAs) and the governance crisis in the financial sector. Export to GDP ratio has declined rapidly, with the trade war worsening the situation.

Suggestions

Investment led economy

The Economic Survey 2019 focuses on moving to a "virtuous cycle" of savings, investments and exports to transform India into a $5 trillion economy in the next five years.

When the economy is in a **virtuous cycle,** investment, productivity growth, job creation, demand and exports feed into each other and enable animal spirits in the economy to thrive.

Private investment is a key driver for demand, capacity, labour productivity, new technology adoption, and for job creation.

Moving the economy into a virtuous cycle would require the adoption of certain practices and norms on data, legal reforms and policy certainty, and some microeconomic aspects such as boosting MSMEs and reducing the cost of capital.

There is emphasis on private investment because the government would stick to its fiscal consolidation glide path. It has committed to a fiscal deficit of 3.4% of GDP in 2019-20 and this limits its capacity for capital expenditure.

MSME Sector

The 'dwarf' firms (with less than 100 workers) accounted for more than 50% of all organised firms in manufacturing by number.

Despite this, their contribution to employment was just 14%.

Large firms, on the other hand, are just 15% in number but account for 75% employment.

Therefore, there is a need to "unshackle" MSMEs and enable them to grow into larger firms.

Employment and Labour Reforms

The factories in States that have flexible labour markets are much more productive than those in States with rigid laws. Therefore, there is need of labour reforms

*On average, a UK resident's income was 21 times that of an average Indian in 2018.

Still, the richest 1% of Indians own 58.4% of wealth. The richest 10% of Indians own 80.7 % of the wealth.

Slowdown in Indian Economy

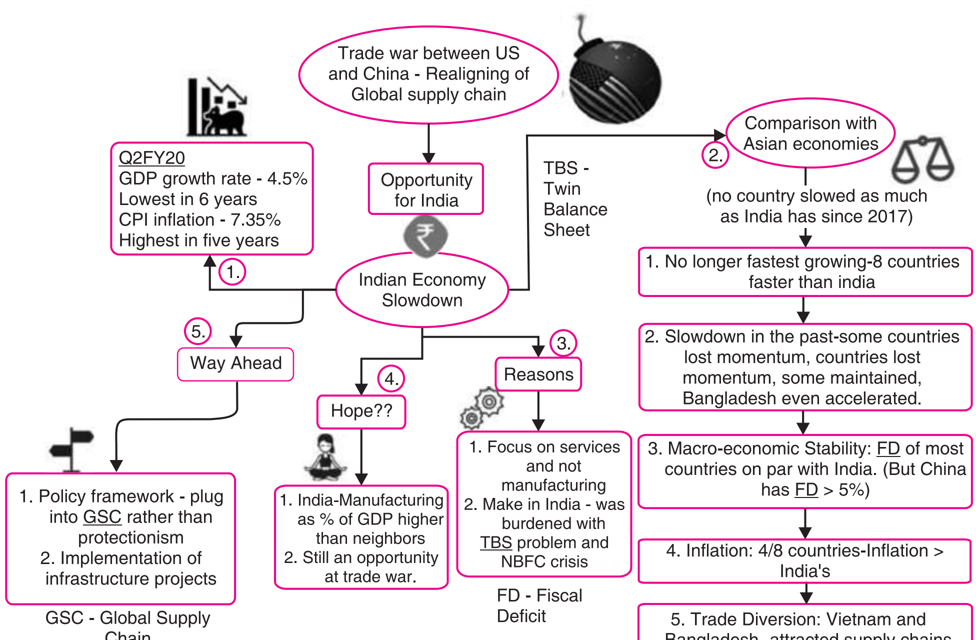
Recent data indicates GDP growth rate for the year 2019-20 was just 4.2%, which is the lowest for the last 11 years. Moreover, the growth rate for Q4 had slipped to 3.1%.

Indian economy is facing a slowdown which is both **structural** (that is, more long-term issues related to the overall framework of the economy such as the flexibility or inflexibility of labour laws, land acquisition issues, rural distress, focus on inflation targeting and fiscal consolidation (it has reduced overall liquidity in the economy, failure of Make in India, etc.) and **cyclical** (which is caused by overheating of the economy or in other since the causes are both **structural and cyclical**, experts say, arresting this economic slowdown is proving to be so difficult.

According to the **Index of Industrial Production (IIP)** data, 18 of the 23 industry groups in the manufacturing sector showed negative growth.

Major component of India's GDP is **investment,** induced by both private and government sectors. The investment rate as measured by **Gross Fixed Capital Formation (GFCF) as a percent of GDP** is showing a declining trend. GFCF as a percent of GDP has declined from 34.3 percent in 2011 to 28.8 per cent in 2018. Domestic investment and consumption are the only dependable drivers for sustainable reacceleration of the economy. Similarly, the GFCF in the private sector declined from 26.9 per cent in 2011 to 21.4 per cent in 2018.

Savings declined from 32.7 percent in 2011 to 29.3 per cent in 2018. The decline in savings rate is because the economy is experiencing a declining wage growth (both rural and urban wages).



Mind Map 1.3

Construction activity also slowed down reflecting the continued dismal performance of the **real estate sector.**

Manufacturing sector is expected to grow barely at 1%, down from 5.7% in the last year.

The growth of the Indian economy had been predominated by consumption inclusive of both — **Private Final Consumption Expenditure (PFCE) and the Government Final Consumption Expenditure (GFCE).** Recently there has been a fall in PFCE growth.

Rural wage growth has declined from 27.7 per cent in FY14 to less than 5 per cent in FY19. The **corporate wages** have also exhibited a single-digit growth in FY19 compared to a double-digit growth a few years back.

During the period from 2011-2018, **exports as a** percent of GDP also declined from 24.5 percent to 19.6 per cent.

The **inflation rate** in the economy has declined from 10.03 per cent in FY13 to 3.41 per cent in FY19. Low inflation rate depicts weakening of demand that would discourage fresh investments and job creation.

Twin balance sheets (TBS) refers to the balance sheets of Indian banks (especially public sector banks or the government-owned banks) and the corporate sector, respectively. The balance sheets of Indian banks were burdened by a high proportion of non-performing loans and the balance sheets of corporate were clogged because they had overborrowed and were unable to pay.

Causes of the Slowdown

Unorganised sector producing 45% of the output and employing 94% of the workforce, has been in decline since demonetisation and GST which is pulling down the rate of growth of the economy. The rise in the demand for work under the Mahatma Gandhi National Rural Employment Guarantee Act, etc. suggests that the **unorganised sector** has declined by **10%.**

Low Investment and High ICOR are other reasons for the growth coming down. An analysis of the data of the period since 2012-13 reveals two trends. First, there has been a decline in investment rate. Second, the decline in growth rate is greater than the decline in investment rate, indicating a rise in the incremental capital-output ratio (ICOR). In 2007-08, India's investment rate was 38% of GDP. It declined steadily to touch 34.8% in 2012-13. The declining trend continued in 2015-16. With an ICOR of 4, only a return to a higher level of savings and investments can take us back to 8-9% growth seen earlier. Thus, what is needed to achieve the "higher growth rate" is to raise the Investment rate and improve the productivity (or use) of capital.

The key reason for the slowdown in the **automobile sector** is the confusion over the policy on electric cars. NITI Aayog had proposed the ban on sale of three-wheelers with internal combustion engines by 2023 and two-wheelers with engine capacities less than 150 cc by 2025. The 150 cc and below segment form almost 90% of the two-wheeler market in the country.

Also, new safety and emissions standards increased the cost of vehicles, nine states raised taxes on car sales, and the banks and finance companies which fund dealers and 80 percent of consumer car purchases were paralyzed by the credit crunch. The sharp increase in road tax in many States added to the problem. The switch from BS IV to VI engines for improved emission standards has also led to the slump due to increased cost of production.

Stagflation: With CPI inflation hitting a high of 7.4% in November and Food inflation hit 10%, vegetables (onions) and pulses. This has led to worries about India entering a phase of stagflation, (persistent high inflation combined with high unemployment and stagnant demand in a country's economy). The current slowdown is closer in nature to what was faced as far back as 1991.

Why is stagflation dangerous? In a normal low growth situation, the government or the central bank can provide economic stimulus via higher public spending and cut interest rates. But in stagflation, when inflation is already running high, fiscal and monetary stimulus can make it worse as that puts more money in the hands of the consumer and inflation will increase drastically.

Global Economy: With the **US-China Trade war and Brexit,** global sentiments have remained poor, making the prospects of an export-led growth bleak. Emerging market economies have also started showing some weaknesses. E.g. Brazil and South Africa have already got into the recessionary stage.

Lesser consumption demand: Weak income growth, especially rural, has been affecting private consumption.

Corporate and Environmental regulatory uncertainty: Private investment has been hindered by the financial sector difficulties (including in the public sector banks (PSBs) and insufficient business confidence. **Implementation issues with some structural reforms** like goods and services tax (GST) have also affected the growth process.

Tight monetary and fiscal policy: Since 2016-17, the monetary policy was focused on inflation. Combined fiscal deficit of the centre and the state was high. And the government committed to lowering its fiscal deficit, it left little room for the government to increase its spending to boost the economy.

Financial sector: Stress in the financial sector due to rising NPAs and NBFC crisis created liquidity crunch. The overhang of **bad bank loans,** coupled with recent defaults by nonbank financial firms has curbed lending to consumers and businesses.

NBFCs Failure: NBFCs' share of credit has increased because they were lending in sectors where banks refused to go or did not want to go. Now as NBFCs are finding it difficult to raise money from the market because of the IL & FS issue or having to pay a huge cost for doing so, this will choke the flow of credit to the economy. It will hit the MSME sector which is already suffering from the twin blows of demonetisation and the goods and services tax. It will hit consumption demand in the economy (consumption was the primary engine driving the economy since 2013). A reduction in credit further adds to economic slowdown pressures, which are already visible. Slowdown in credit could lead to another pile of non-performing assets in sectors such as commercial real estate and infrastructure, which could have economy-wide knockdown effects.

Can India grow at 8-9% per annum?

The Indian economy is currently passing through a phase of relatively slow growth. However, over the 9-year period beginning 2005-06, the average annual growth rate was 7.7%. Against this background, the relevant question is whether India has the capability to grow at 8-9% in a sustained way.

Past Performance India achieved a growth rate of 9.5% in 2005-06 followed by 9.6%, and 9.3% in the subsequent 2 years. After declining a bit in the wake of the international financial crisis, the growth rate went back to 8.9% in 2010-11. The domestic savings rate during this period averaged 34.9% of GDP. Similarly, the growth capital formation rate averaged 36.2%

Peculiar case of India's growth story

Services led growth: India's economic growth is mainly on account of growth in the services sector. It has bypassed the stage of growth in the secondary sector. India has witnessed high growth in the services sector due to the following reasons:

Low cost of workers

Availability of English-speaking personnel: People who can speak English and, thus, provide services abroad.

Information technology has facilitated delivery of services from India to anywhere across the world.

On the other hand, India has not witnessed much growth in the secondary sector due to the following reasons:

Late entry of the private sector in the economy due to delayed liberalization

Competition from Chinese goods, which are available at cheap prices and are available in wide range,

Poor quality of infrastructure enhances the cost of doing business and hampers the pace of business operations. For instance, electricity produced by diesel can cost twice as much as the energy produced from coal or hydropower based systems. High energy costs combined other infrastructure deficits, such as rail and road problems, have lowered the productivity rates of manufacturing industries in India.

Excessive rules and regulations in India (or red-tapism). For example, securing numerous clearances before setting up a business enhances the cost of functioning of business. The high cost functioning makes survival difficult for the business in the highly competitive environment. Difficulty in starting a business dissuades people from entering into business activity.

Consequences of Low Growth in Secondary Sector- The secondary sector produces machinery for use in primary and tertiary activities. Slow secondary sector hampers mechanization and automation in the primary and tertiary sector.

Steps taken by the Government to revive Economy

1. **Capital infusion in banks:** The government announced upfront capital infusion of ₹ 70,000 crore into public sector banks.
2. **Merger of banks:** The government announced the merger of 10 public sector banks into four.
3. **Rollback of surcharge on FPI:** The government has announced rollback of enhanced surcharge on foreign portfolio investors and domestic portfolio investors which was announced in budget. The government also announced to simplify KYC for FPI.
4. **No angel tax:** it will be withdrawn for start-ups and their investors.
5. **FDI easing:** Government allowed 100% FDI in commercial coal mining and allowed as much in contract manufacturing through the automatic route. Government also relaxed 30% local sourcing norms for single-brand retail.
6. **Relief for Indian companies:** The finance ministry notified a scheme to settle the indirect tax disputes in the pre-GST era, named **Sabka Vishwas legacy dispute resolution scheme**, which was announced in the union budget for FY20.
7. **Relief in CSR:** CSR violations will not be treated as criminal offence, instead they will be treated as civil violations.
8. **To boost real estate:** The government announced Rs.30,000-crore liquidity support to the struggling housing finance companies (HFCs).
9. **Help for MSME:** MSMEs to get all their pending GST refunds within 30 days. Further, all GST refunds of micro, small and medium enterprises (MSMEs) will be paid within 60 days from the date of application.

Way Forward

1. **A reduction in GST to 18% from the current rate of 28%** will help in an immediate price reduction and boost demand.
2. **Balance sheet issues** including the commercial banks, the corporate sector, and the NBFCs including housing finance companies should be resolved on the earliest.
3. In **Fiscal policy** suggestions, in the short term, focus on rationalising GST. **Over the medium-term,** focus should be on domestic revenue mobilisation like increasing personal income tax collections by ending exemptions, reducing the minimum threshold for taxpayers.
4. **Labour, land, and product-market reforms** should be brought for enhancing competition and governance.

India's GDP has been affected by different factors at different times. This is a cyclical phenomenon and will pass like the circle of life. What goes up, must come down, but govt must also address the concerns of economy.

One of the reasons for the current slowdown has been the weak demand in the country especially from the rural sector. Thus, the government should try to **increase disposable incomes** (through schemes like MGNREGA) in the hands of people which will revive the growth in the economy.

Only **long-lasting structural changes** can improve the growth potential of the Indian Economy and deter the possibility of three slowdowns within the short span of a decade.

Need for Fundamental Reform

The need of the hour is to focus on fundamental reforms. Easing land acquisition and labour rules could attract new business projects, revive mass recruitment and lift the economy's growth capacity to a new level. A reliable social security net would help bring down resistance to relaxing rules that deter companies from multiplying their payrolls. With added assurances of state support, a relatively flexible labour market could be achieved.

Less risky but more complex would be **capital market reforms.** On these, the government should start with the banking sector, which remains overly state-dominated and needs market oversight to stop good money from being thrown after bad. The state needs to either withdraw from other fields of business or turn public sector enterprises uniformly profitable.

The autonomy of institutions such as the Reserve Bank of India and Election Commission should be guaranteed via devices that are open to public scrutiny. Independent regulation would assure all participants fair treatment and check legislative and market forces that could imperil the economy and our democracy.

The government must commit to making India's economic statistics modern, world-class and immune to political interference. The first thing about "fixing" the economy is to measure it right and without "bias".

Employment: Jobs are the most significant economic and political priority for the coming decade.

The two major foundational pillars for job growth for the medium and long term are - An industrial apprentice and vocational training system in India and a quantum jump in the quality of our school education. India's vocational streaming and training system delivered primarily through a chain of **Industrial Training Institutes (ITIs)** is broken. Revamping this broken system—from streaming high-school youth into the vocational path to improving the quality and relevance of vocational education, and also creating an **apprentice supply chain** from these institutes into the workforce - will help. Beyond this long-term fix, it is time for India's "Green New Deal". This New Deal should focus on employment generation for environmentally sustainable infrastructure projects funded by the government. **Resources for this New Deal** can only come from higher productivity and structural GDP growth, so undertaking structural reforms can become a self-fulfilling project.

Banking reform: Structural reforms require three forms of capital—talent/governance, equity and debt. The government cannot fully fix the problems of public sector banks with capital if it is not accompanied by governance reforms. The government must immediately transfer its ownership in public sector banks to an **empowered agency in the form of an exchange traded fund (ETF).** This new agency must be empowered to delink these banks from all forms of governmental interference. The government must fully privatize IDBI Bank—the only public sector bank set up as a private limited company. With the advantage of time and an electoral majority, the centre should insist on accountability in the governance of all public sector banks.

Agriculture reforms should be initiated to counter the rural distress. For decades, Indian governments have largely failed in their attempt to improve agricultural productivity and provide alternative occupational paths for rural households. Focus should be on structural fixes that include access to better seeds and technology, drip irrigation and crop planning for the farmer, an easier path from farms to markets for products, a steadier offtake of farm products and a reduction in middleman costs. A direct cash transfer to the marginal farmer can and should cushion this reform process.

Package to Spur Economic Growth- Finance minister announced measures to revive growth, boost consumption and uplift investor and consumer sentiment.

Impact of COVID-19 Pandemic on Economy

Possibility of Biggest Depression

World had witnessed **two great depressions- The Great Depression (GD)** of the 1930s and **2008 global financial crisis (GFC).** There is high possibility that COVID-19 could cause the history's biggest economic depression (sustained, long-term downturn in economic activity in one or more economies) given the number of people and economies it has affected.

Impact of the previous two depressions – GFC & GD of 1930s

- Stock markets collapsed by 50% or more
- Credit markets froze up
- Massive bankruptcies of firms followed
- Unemployment rates soared above 10%
- GDP contracted at an annualized rate of 10% or more

In the current COVID-19 crisis, similar outcomes have materialized thus exacerbating the possibility of Depression. COVID induced depression is **more severe & faster.** Analysts fear that the global economy may tip into a recession.

The problem with current predictions is no one knows how long the virus will remain potent.

As per the **International Monetary Fund's (IMF) World Economic Outlook (WEO),** COVID-19 pandemic is having a **'severe' effect on the world economy.** The economy is expected to **contract by 3%** in 2020, which will be much worse than the 2008-09 financial crises.

As countries implement necessary quarantines and social-distancing practices to contain the pandemic, the world has been put in a **great lockdown** due to which all the **economic activities** have been **affected.**

The **cumulative loss** to global GDP over 2020 and 2021 from the pandemic crisis could be around $9 trillion, **greater than the economies of Japan and Germany, combined.**

GDP contracts by 23.9%

According to the recent **National Statistical Office (NSO)** data, India's **Gross Domestic Product (GDP)** growth **contracted by 23.9%** in the first (April-June) quarter of 2020 compared to the same period (April-June) in 2019.

India's economy posted the biggest contraction among major economies last quarter, with a recent surge in coronavirus infections weighing on the outlook for any recovery.

Gross domestic product shrank 23.9 percent in the three months to June from a year earlier, the Statistics Ministry said in a report Monday. **That's the sharpest decline since the nation started publishing quarterly figures in 1996, and was worse than any of the world's biggest economies tracked by Bloomberg.** The median estimate in a survey of economists was for an 18 per cent contraction.

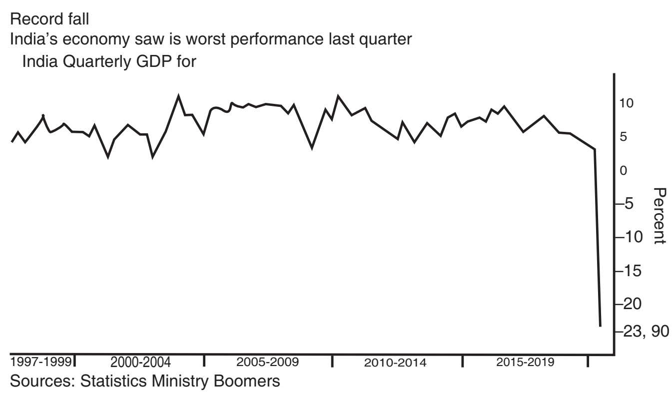


Image 1.4

Construction, manufacturing, trade, hotels and other services and **mining** were the worst-hit sectors, recording contractions of **50.3%, 39.3%, 47.0% and 23% respectively.** This reflects the unprecedented suspension of economic activity in the first quarter of this fiscal due to the **pandemic** and the series of lockdowns. Only the **agriculture sector** showed a **positive growth** at 3.4%.

Factors of GDP Contraction

In any economy, the GDP growth is generated from one of the four engines of growth i.e. private consumption, demand generated by private sector businesses, demand generated by government and exports.

Private consumption has fallen by 27%. It is the biggest engine that drives the Indian economy.

Investments by private sector businesses have fallen by 47%. It is the second biggest engine.

The net export demand has turned positive in this first quarter because India's imports have crashed more than its exports.

While on paper, this provides a boost to overall GDP, it also points to an economy where economic activity has plummeted.

The government's expenditure went up by 16% but this was nowhere near enough to compensate for the loss of demand in other sectors (engines) of the economy.

Implications

On Jobs: The sectors which have contracted (e.g. construction, manufacturing, etc.) are the sectors that create the maximum new jobs in the country. Therefore, in a scenario where each of these sectors are contracting, would lead to more and more people either losing jobs (decline in employment) or failing to get one (rise in unemployment).

On Informal Sector: The real extent of the economic crisis is expected to be deeper given that the small-scale sector and informal sector is more affected than the organised sector, but is not reflected in the quarterly GDP numbers. In the informal sector, factory output figures are used to extrapolate the trends in the growth.

On Banks: The looming defaults in the banking sector after the moratorium ends will add to the banking sector woes, impacting bank's lending. Also, there are worries regarding household debt, with incomes stagnating, salary cuts and job losses.

On Economy: With GDP contracting by more than what most observers expected, it is now believed that the full-year GDP could also worsen. A fairly conservative estimate would be a contraction of 7% for the full financial year.

Way Forward

As the incomes of individuals fall sharply, they reduce consumption. When consumption falls sharply, businesses stop investing. Since both of these are voluntary decisions, there is no way to force people to spend more and/or coerce businesses to invest more. The same logic holds for exports and imports as well.

Therefore, under these circumstances, there is only one engine that can boost GDP that is the government. Only when the government spends more — either by building roads and bridges and paying salaries or by directly handing out money — can the economy revive in the short to medium term. If the government does not spend adequately enough then the economy will take a long time to recover.

The Indian Government can also adopt the **measures suggested by McKinsey Global Institute** in which an additional 3.5% of the GDP can be raised by the government. This includes:

Global Shift: Global trends such as digitization and automation, shifting supply chains, urbanization, rising incomes and demographic shifts, and a greater focus on sustainability, health, and safety can become the hallmarks of the post pandemic economy.

Higher Productivity through Privatisation: Privatisation of 30 or so of the largest state-owned enterprises to potentially double their productivity. Government also had a focus on privatisation under the Atmanirbhar Bharat Package.

Improvement in Infrastructure: India needs to unlock supply in land markets to reduce land costs by 20-25%, enable efficient power distribution to reduce commercial and industrial tariffs by 20-25%; and improve the ease and reduce the cost of doing business.

Efficient Financing: Streamlining fiscal resources can deliver USD 2.4 trillion in investment while boosting entrepreneurship by lowering the cost of capital for enterprises by about 3.5 percentage points.

Bad Bank: Creation of a 'bad bank' can take care of the inoperative assets.

1.3 : ECONOMIC DEVELOPMENT, INDICES & REPORTS

Economic Growth

An **increase in GDP over a period of time is economic growth.** The most important aspect of growth is its quantifiable i.e. one can measure it in absolute terms.

Economic Development

For a comparatively longer period of time after the birth of economics, economists remained focused on aspects of expanding the quantity of production and income of a country. The main issue economists discussed was – how to increase the quantity of production and income of a country. It was believed that once an economy is able to increase its production, its income will also increase and there will be an automatic improvement (increase in quality) in the lives of people. There was no conscious discussion over the issue of quality of life of the people. Economic growth was considered as a cause for the betterment of the lives of people. This was the reason why economists, till the 1950s, failed to differentiate between growth and development.

It was during the **1960s** and in the later decades that economists came across many countries where the growth was comparatively higher, but the quality of life was comparatively low e.g. in Gulf countries. The time had come to define economic development differently from economic growth.

For economists, development indicates the increased quality of life in the economy, which can be judged from the level of education, level of health indicators etc.

If the people are to be guaranteed with a basic minimum level of quality of life- enhancing inputs such as food, health, education, etc. in their life, then they have to be provided with a minimum level of income.

Income is generated from productive activities. It means that before assuring development, we need to assure growth. **Higher economic development requires higher economic growth.** But it **doesn't mean that a higher economic growth automatically brings in higher economic development.**

When we use the term development we mean quantitative as well as qualitative progress. If economic growth is suitably used for development, it comes back to increase the growth and ultimately a greater and greater population is brought under the arena of development. Similarly, high growth with low development finally results in fall of growth. Thus there is a circular relationship between growth and development.

The story in a nutshell, therefore, is "Growth is only a necessary condition and not a sufficient condition for development".

Measuring Economic Development

HDI

The dilemma of measuring the development level of economies was solved once the **UNDP (United Nations Development Programme)** published its first Human Development report (HDR) in 1990. The report had a Human Development Index (HDI) which was the first attempt to define and measure the level of development of countries.

The **Human Development Index (HDI)** was developed by the Pakistani economist Mahbub ul Haq working alongside Indian economist Amartya Sen and was published by the United Nations Development Programme. It ranks countries into 4 tiers of human development.

Human Development Report (HDI) combines **three dimensions**

A long and healthy life measured by life expectancy at birth

Education index measured by mean years of schooling and expected years of schooling

A decent standard of living measured by GNI (GNP) per capita (PPP US$)

The following **three indices** are used:

1. **Life Expectancy Index (LEI):** LEI is 1 when Life expectancy at birth is 85 and 0 when Life expectancy at birth is 20.
2. **Education Index (EI) :** Consists of

   Mean Years of Schooling Index (MYSI): Mean years of Schooling is the years that a person 25 years of age or older has spent in schools. Fifteen is the projected maximum of this indicator for 2025.

Expected Years of Schooling index (EYSI): Expected years of schooling for children. Eighteen is equivalent to achieving a master's degree in most countries

3. **Income Index (II):** II is 1 when GNI per capita is $75,000 and 0 when GNI per capita is $100. GNI is Gross national Income at purchasing power parity per capita.

Finally, the HDI is the **geometric mean** of the previous three normalized indices.

In the recently released rankings of the Human Development Index (HDI), by the United Nations Development Programme (UNDP) for the year 2019, India was ranked 129th. Although the country's rank is up from 2018's (130), it's still disappointing, considering that 189 countries are taken into account.

GDI (Gender Development Index)

It is the ratio of female HDI to male HDI.

Gender Inequality index

The disadvantages facing women and girls are a major source of inequality. Many women and girls are discriminated against in health, education, political representation, labour market, etc — with negative effects on the development of their capabilities.

The GII measures gender inequalities in **three important aspects** of human development—

1. **Reproductive health,** measured by maternal mortality ratio and adolescent birth rates

   Maternal mortality rate refers to deaths due to complications from pregnancy or childbirth per 1Lakh live births. India's MMR in 2015 was 122.

   Adolescent birth rate measures the annual number of births to women 15 to 19 years of age per 1,000 women in that age group. And while 28 of every 1,000 Indian adolescent women (age 15-19) gave birth between 2006 and 2017, the global adolescent birth rate was over one-and-a-half times that of India, at 44 per 1,000. India's fertility rate in 2019 is 2.3 births per woman, compared to 2.5 worldwide.

   Infant mortality rate is the death of an infant before his or her first birthday. The infant mortality rate is the number of infant deaths for every 1,000 live births. India's IMR was 30 in the year 2020.

2. **Empowerment** measured by proportion of parliamentary seats occupied by females and proportion of adult females and males aged 25 years and older with at least some secondary education;

3. **Economic status** expressed as labour market participation and measured by labour force participation rate of female and male populations aged 15 years and older.

LFPR (Labour Force Participation Rate) is the number of people who are working or looking for work divided by total working age population (16-64 years. E.g. if total population of a country is 100 and there are 64 people in the working age, then a LFPR of 50% means that 32 people are either working or looking for work, and the other 32 are neither working nor looking for work. They may be students who are upgrading their skills or may be housewives. Unemployment rate of 10% in the above means that 3.2 people are looking for work but are not able to get work at the current wages but 28.8 people are working.

The GII is built on the same framework as the IHDI — to better expose differences in the distribution of achievements between women and men. It measures the human development costs of gender inequality, thus the **higher the GII value the more disparities between females and males** and the more loss to human development.

Multi-Dimensional Poverty Index

The Global Multidimensional Poverty Index (MPI) was **developed in 2010 by the Oxford Poverty & Human Development Initiative (OPHI)** and the **United Nations Development Programme** and uses different factors to determine poverty beyond income-based lists. It complements the previous Human Poverty Index. The global MPI is released annually by OPHI.

The global Multidimensional Poverty Index (MPI) is an **international measure of acute poverty covering over 100 developing countries.** It complements traditional income-based poverty measures by capturing the severe deprivations that each person faces at the same time with respect to education, health and living standards. The MPI **assesses poverty at the individual level.** If someone is deprived in a third or more of ten (weighted) indicators, the global index identifies them as 'MPI poor', and the extent – or intensity – of their poverty is measured by the number of deprivations they are experiencing. The MPI can be used to create a comprehensive picture of people living in poverty, and permits comparisons both across countries, regions and the world and within countries by ethnic group, urban/ rural location, as well as other key household and community characteristics.

These characteristics make the MPI useful as an analytical tool to identify the most vulnerable people - the poorest among the poor, revealing poverty patterns within countries and over time, enabling policy makers to target resources and design policies more effectively.

Indicators

The index uses the same three dimensions as the Human Development Index: health, education, and standard of living. These are measured using **ten indicators.**

Dimension	Indicators
Health	Child Mortality Nutrition
Education	Years of Schooling, School Attendance
Living Standards	Cooking fuel, Toilet, Water, Electricity, Floor Assets

Indicators used

The following ten indicators are used to calculate the MPI

Education (each indicator is weighted equally at 1/6)

Years of schooling: deprived if no household member has completed six years of schooling

- **Child school attendance:** deprived if any school-aged child is not attending school up to class 8 Health (each indicator is weighted equally at 1/6)
- **Child mortality:** deprived if any child has died in the family in past 5 years
- **Nutrition:** deprived if any adult or child for whom there is nutritional information is stunted. Standard of Living (each indicator is weighted equally at 1/18)
- **Electricity:** deprived if the household has no electricity

Sanitation: deprived if the household's sanitation facility is not improved (according to MDG guidelines), or it is improved but shared with other households

Drinking water: deprived if the household does not have access to safe drinking water (according to MDG guidelines) or safe drinking water is more than a 30-minute walk from home roundtrip

Floor: deprived if the household has a dirt, sand or dung floor

Cooking fuel: deprived if the household cooks with dung, wood or charcoal

Assets ownership: deprived if the household does not own more than one of: radio, TV, telephone, bike, motorbike or refrigerator and does not own a car or truck

A person is considered poor if he is deprived in at least a third of the weighted indicators. The intensity of poverty denotes the proportion of indicators in which they are deprived.

Global Hunger Index

Global Hunger Index (GHI) Report is prepared by the **Concern Worldwide** (an Irish agency) and the **Welt hunger hilfe** (a German organization)

The GHI scores are based on a formula that captures **three dimensions of hunger**—insufficient caloric intake, child undernutrition, and child mortality—using **four component indicators** namely, undernourishment (insufficient caloric intake), child stunting, child wasting, and child mortality (mortality rate of children under the age of five).

India's child wasting rate was extremely high at 20.8% - the highest

India's rank has slipped from 95th position (in 2010) to 102nd (in 2019)

Child wasting refers to the share of children under the age of five who are wasted, i.e. they have low weight with respect to their height, reflecting acute undernutrition.

Child stunting is when children have low height for their age. Neighbouring countries bagged better spots — Sri Lanka (66), Nepal (73), Pakistan (94) and Bangladesh (88). The data shows that India's poor scores were pulling down South Asia to a point where it does worse than even sub-Saharan Africa

Gross National Happiness Index

Gross National Happiness is a term **coined by the Fourth King of Bhutan, Jigme Singye Wangchuck** in the 1970s. The concept implies that sustainable development should give equal importance to economic as well as non-economic aspects of well-being. GNH is a much richer objective than GDP or economic growth. In GNH, material well-being is important, but it is also important to enjoy sufficient well-being in things like community, culture, governance, knowledge and wisdom, health, spirituality and psychological welfare, a balanced use of time, and harmony with the environment.

It has the following parameters

(i) Higher per capita income

(ii) good governance

(iii) environmental protection

(iv) cultural promotion (i.e. inculcation of ethical and spiritual values in life without which a program may become a curse than a blessing).

Inclusive Development Index

Inclusive Development Index was **released recently by the World Economic Forum.** It has been developed as a new metric of national economic performance. It is seen as an alternative to GDP. The Index on inclusiveness reflects more closely the criteria by which the people evaluate their countries' economic progress. The index has three pillars of growth for global economies namely:

1. Growth and development
2. Inclusion
3. Intergenerational equity and sustainability

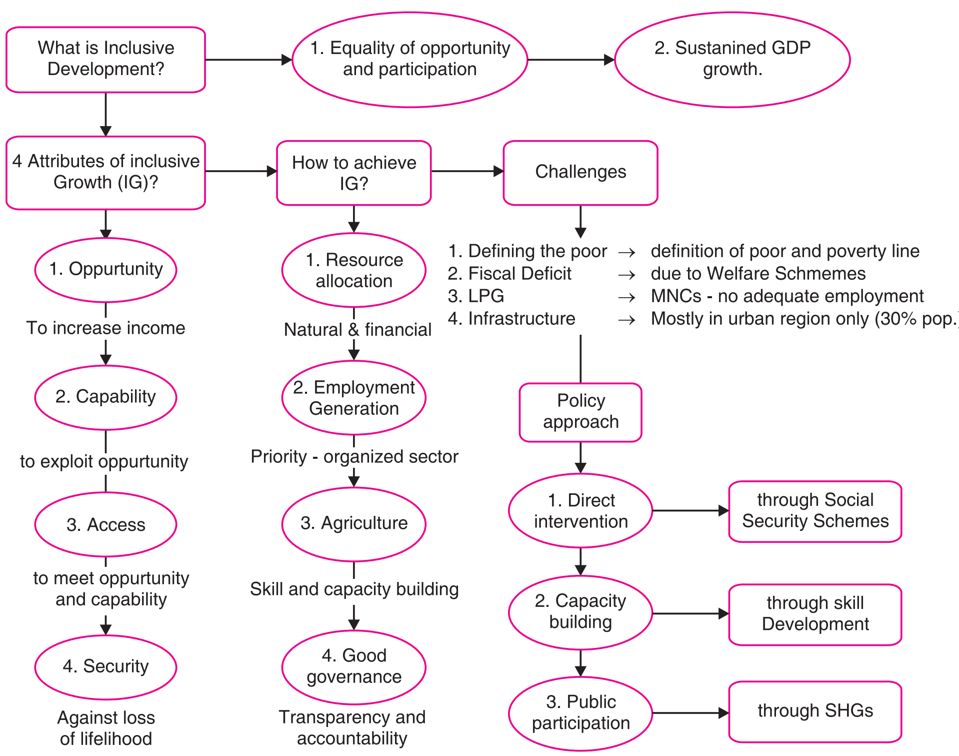
Inclusive Growth

Inclusive growth basically means making sure everyone is included in growth, regardless of their economic class, gender and religion. Inclusive growth is economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity to every section of the society. It yields broad based benefits and stands for growth with social justice. This concept expands upon traditional economic growth models to include focus on health, human capital, environment quality, social protection and food security.

Growth is inclusive when it takes place in the sectors in which the poor work (agriculture), occurs in places where the poor live (undeveloped areas with few resources like slums and rural areas) uses the factors of production that the poor possess (unskilled labour) and reduces the prices of consumption that the poor consume (food, fuel, clothing). The equality of opportunity and participation in growth by all with a special focus on the most vulnerable people of the society are the very basis of inclusive growth.

There is a difference between direct income redistribution or shared growth and inclusive growth. The inclusive growth approach takes a longer term perspective as the focus is on productive employment rather than on direct income redistribution as a means of increasing income of excluded groups. In the short run, governments could use income redistribution schemes to reduce the negative impacts on the poor of the policies intended to jump start growth, but transfer schemes cannot be an answer in the long run and can be problematic also. In poor countries, such schemes can impose burden on the budgets and it is theoretically impossible to reduce poverty through redistribution. Inclusive growth is therefore supposed to be inherently sustainable as distinct from income redistribution schemes. While income distribution schemes can allow people to benefit from economic growth in the short run, inclusive growth allows people to contribute to and benefit from economic growth in a sustainable manner.

Rapid and sustained poverty reduction requires inclusive growth that allows people to contribute to and benefit from economic growth. Rapid pace of growth is unquestionably necessary for substantial poverty reduction, but for this growth to be sustainable in the long run, it should be broad based across sectors and inclusive of the large part of the country's labour force.



Mind Map 1.5

How can Inclusive Growth be Achieved?

Resource allocation: Without proper resource (financial/ natural) allocation, the issues of poverty and development can be solved. Equitable sharing of resources is required.

Employment generation: it is the most strategy to achieve inclusive growth. It will have to be in the organized sector.

Focus on agriculture:

Skill building and capacity development

Decentralization

Good Governance (Transparency and accountability):

Financial Inclusion

CSR (Corporate Social Responsibility)

Women empowerment

Access to essential services

Equality of opportunity of access to market and resources

Challenges to Inclusive Growth

Defining the poor- Without a proper definition of poverty and Poverty line, a policy framework for inclusive growth can't be developed.

Fiscal Deficit: Welfare schemes by the government will increase the fiscal deficit.

Effects of LPG: LPG promotes MNCs, which are capital intensive, hence they don't create adequate employment. Moreover, MSMEs, which are labour intensive, don't stand a chance against the MNCs.

Infrastructure: Most of the infrastructure spending is for the industrial sector, while 55% of people depend on agriculture. Moreover, most of the infrastructure is developed in the urban areas, while 70% people live in the villages.

Low technology and innovation

Benefits of Inclusive Growth

Broad based and **sustainable growth** (sustainable at both financial and environmental level).

Demographic dividend

Decrease in incidents of violence, theft, naxalism

Women empowerment

To achieve the **equity objective**

Mains Model Answer by IAS Toppers

It is argued that the strategy of inclusive growth is intended to meet the objectives of inclusiveness and sustainability together. Comment on this statement.

(2019 – 250 words, 15 marks)

Organization for Economic Co-operation and Development (OECD) defines Inclusive growth as the economic growth that is distributed fairly across society and creates opportunities for all. It refers to 'broad-based', 'shared', and 'pro-poor growth'.

Inclusiveness encompasses equity, equality of opportunity, and protection in market and employment transitions and is therefore an essential ingredient of any successful growth strategy. On the other hand, sustainable development is a kind development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

Among the 17 Sustainable Development Goals (SDGs) framed by UN, the goals 8,11 and 12 also mention about inclusiveness and sustainability of the growth process.

Inclusive growth has many positive aspects including;

- Lower incidence of poverty.
- Broad-based and significant improvement in health outcomes.
- Universal access for children to school.
- Increased access to higher education and improved standards of education, including skill development.
- Better opportunities for both wage employment and livelihood.

- Improvement in provision of basic amenities like water, electricity, roads, sanitation and housing.

  All these aspects are intended to meet the objectives of both inclusiveness and sustainability. A growth which is inclusive can only be sustained over a period of time and won't be hurting the growth process of anyone, be it present generation or future. Also a sustainable growth becomes inclusive growth because when environment is hurt then it is the poor sections which are hurt the most.

  Hence, if in a growth process, if we are taking care of the environment, we are taking care of the interests of the poor sections.

  Inclusive growth addresses the structural and fundamental problems in society and the economy. E.g. current strategy to empower women. These strategies build strong foundations that are more sustainable for long term transformations. In the past few years, the government is aggressively focusing on the strategy of inclusive growth in its various programs and policies. e.g., Jan Dhan Yojana.

  In growth which is 'inclusive' and "pro-poor", the incomes of poor people grow faster than those of the population as a whole, i.e., inequality declines. By focusing on inequality, inclusive growth could lead to optimal outcomes for both poor and non-poor households.

  India's growth story has been phenomenal but the outcomes of this growth were not visible on the ground as India has performed badly in several social indicators. Therefore, inclusive growth is the idea to realize the dream of sustainable and qualitative development for present and future generations.

Mains Model Answers by IAS Toppers

What are the salient features of 'inclusive growth'? Has India been experiencing such a growth process? Analyze and suggest measures for inclusive growth. (2017 – 250 words, 15 marks)

Socio economic justice and equality of status and opportunity is reflected in India's constitution. Deriving from this, the salient features of inclusive growth are:

- Uplifting the weaker sections
- Giving a share of growth pie to all
- Expanding the choices of people
- Emphasizing on social and political inclusion as well

  Special measures by various governments have enabled growth to be inclusive:
- Five Year plans with focus on economy, equity, faster and sustainable growth
- Green Revolution, operation flood increasing the availability and affordability of food, thus reducing the burden on poor
- Placing people at the centre of growth process with nationalisation of banks, region specific programmes (DDP, DPAP, HADP...etc), IRDP and rights based inclusion through FRA, MGNREGA, RTE, RTI and digitisation.
- Reducing the number of poor during the MDG period and now working on SDGs shows the inclusive nature of growth.

  On the other hand, agriculture distress, slow job growth, marginalisation of dalits, minorities, tribals, high (70%) out of pocket expenditure on health, disasters and the inequality in resilience to face them is making growth not so inclusive.

  Some measures towards inclusion are:
- Increasing public expenditure in agriculture
- Increasing efficiency and amount of expenditure in health and education to utilize the demographic dividend.
- Suitable, safe and stable jobs to women, low skilled labour
- Improving resilience of poor in dealing with climate change
- Adhering to fundamental rights of equity and equality in all realms

  Strengthening practice of giving back and CSR (Corporate Social Responsibility) The process of inclusive growth has to be continuous and adaptive to the changing scenarios. (267 words)

Capitalism has guided the world economy to unprecedented prosperity. However, it often encourages short-sightedness and contributes to wide disparities between the rich and the poor. In this light, would it be correct to believe and adopt capitalism for bringing inclusive growth in India? Discuss. (2014 – 200 words, 12.5 marks)

Western economies rose to being global superpowers on the foundations of capitalism. Capitalism as an economic policy is adopted because:

Capitalism increases the size of economy

It creates jobs, enterprises.

It rewards merit.

It lets market own the supply and demand thus leaving less scope for government to manipulate.

It emphasizes on wealth creation which can be shared.

But trickle down has not happened as expected in India and inclusiveness still remains an illusion and inequality a reality. This can be substantiated by:

World Bank has found that, over 20% of Indians still remain poor, 29% of SCs and 43% of STs are poor. This shows poverty alleviation vis-a-vis market led growth has not been inclusive.

Even in the future, capitalism in its absolute form can hamper inclusive growth because:

It does not recognise depressed communities like women, dalits, tribals, etc. who need helping hand.

It puts profit ahead of people.

It creates monopolistic tendencies and encourages concentration of wealth.

It widens rich poor divide as seen in India's increasing Gini Coefficient since 1990.

Capitalism in its quest for growth does not care for the environment also.

Therefore, the pitfalls of capitalism have to be avoided and government should play a strong facilitator role in bringing inclusive growth.

Ease of Living Index and Municipal Performance Index

The Ministry of Housing & Urban Affairs launched two Assessment Frameworks, viz. Ease of Living Index (EoLI) and Municipal Performance Index (MPI) 2019.

These Indices will help to assess the progress made in cities through various initiatives and empower them to use evidence to plan, implement & monitor their performance.

Both these indices are designed to assess quality of life of citizens in 100 Smart Cities and 14 other Million Plus Cities.

Ease of Living Index (EoLI) 2019

It is aimed at providing a holistic view of Indian cities-services provided by local bodies, effectiveness of administration, outcomes generated through these services in terms of liveability within cities and citizen perception of these outcomes.

EoLI 2019 will facilitate the assessment of ease of living of citizens across **three pillars:** Quality of Life, Economic Ability and Sustainability

Municipal Performance Index (MPI) 2019

It will assess performance of municipalities on five enablers- Service, Finance, Planning, Technology and Governance

This will help Municipalities in better planning and management, filling gaps in city administration and improving liveability of cities.

India VIX index

- India VIX is the short name for the India Volatility Index, an **index disseminated by the NSE (National Stock Exchange)**
- It measures the degree of volatility or fluctuation that active traders expect in the Nifty 50 over the next 30 days
- **Volatility** is often described as the "rate and magnitude of changes in prices" and in finance is often referred to as risk.

Global Innovation Index

The Global Innovation Index (GII) aims to **capture the multi-dimensional facets of innovation.**

GII rankings are **based on 80 indicators,** from traditional measurements like research and development investments and international patent and trademark applications.

It is **published by** a specialized agency of the United Nations – the World Intellectual Property Organisation **(WIPO)** in association with **Cornell University** and graduate business school **INSEAD.**

India has **improved** from its previous year rank of 57 to 52 in the Global Innovation Index 2019. There has been **consistent improvement in the past few years** - 81 in 2015, which rose to 66 in 2016, 60 in 2017 and 57 in 2018.

Major innovation drivers are ICT services exports, graduates in science and engineering, the quality of universities, gross capital formation and creative goods exports.

India Innovation Index

NITI Aayog along with Institute for Competitiveness as the knowledge partner released the India Innovation Index (III) 2019.

The aim is to create a holistic tool which can be used by policymakers across the country to identify the challenges to be addressed and strengths to build on when designing the economic growth policies for their regions.

The Index is calculated as the average of the scores of its **two dimensions - Enablers and Performance.**

The Enablers are the factors that create innovative capacities, grouped in five pillars: (1) Human Capital, (2) Investment, (3) Knowledge Workers, (4) Business Environment, and (5) Safety and Legal Environment.

The Performance dimension captures benefits that a nation derives from the inputs, divided in two pillars: (6) Knowledge Output and (7) Knowledge Diffusion.

The top ten major states are majorly concentrated in southern and western India.

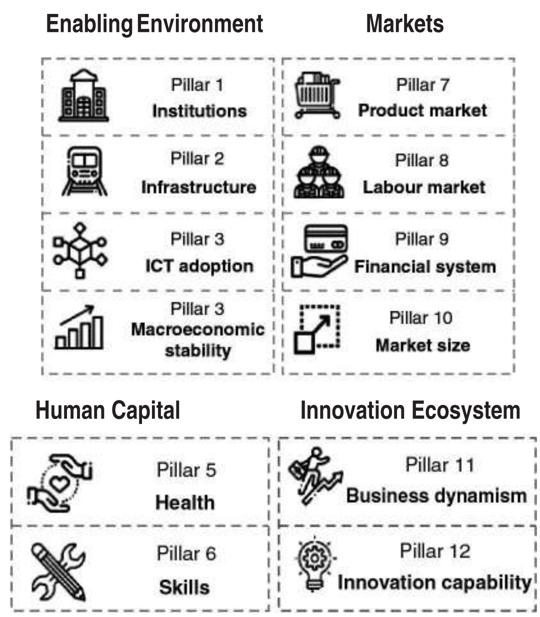
Karnataka is the most innovative major state in India. *Others in top 10 are* Tamil Nadu, Maharashtra, Telangana, Haryana, Kerala, Uttar Pradesh, West Bengal, Gujarat, and Andhra Pradesh.

Global Competitiveness Report 2019

The Global Competitiveness Report 2019 which features the Global Competitiveness Index 4.0 (GCI 4.0) is released by the World Economic Forum.

Since 2018, the **GCI 4.0 methodology** has been used by the Global Competitiveness Report. The GCI 4.0 **provides guidance on what matters for long-term growth.**

The Global Competitiveness Index 4.0 framework



The GCI 4.0 framework is organized into 12 main drivers of productivity, or 'pillars' which is further divided into 4 broad categories.

Singapore is the most competitive nation in the world. In South Asia, India (68) is followed by Sri Lanka (84), Bangladesh (105), Nepal (108) and Pakistan (110).

China's position remained unchanged from last year's survey at 28.

India loses ground in the rankings despite a relatively stable score, mostly due to faster improvements of several countries previously ranked lower.

India's ranking has come down in 2019 to 68, after having improved in 2018 (to 58) from 63 in 2017.

Previous Years' Prelims Questions

2019

1. Consider the following statements:

1. Purchasing Power Parity (PPP) exchange rates are calculated by comparing the prices of the same basket of goods and services in different countries.
2. In terms of PPP dollars, India is the sixth largest economy in the world.

Which of the statements given above is/are correct?

(a) 1 only (b) 2 only

(c) Both 1 and 2 (d) Neither 1 nor 2

Sol. (a) PPP measures the total amount of goods and services that a single unit of a country's currency can buy in another country. The PPP between countries A and B measures the amount of country A's currency required to purchase a basket of goods and services in country A as compared to the amount of country B's currency to purchase a similar basket of goods and services in country B.

India is at number 3rd in terms of GDP at PPP after China and USA

2. The Global Competitiveness Report is published by the
(a) International Monetary Fund
(b) United Nations Conference on Trade and Development
(c) World Economic Forum
(d) World Bank

Sol. (c) The Global Competitiveness Report (GCR) is a yearly report published by the World Economic Forum.

3. Which one of the following is not a sub-index of the World Bank's 'Ease of Doing Business Index'?
(a) Maintenance of law and order
(b) Paying taxes
(c) Registering property
(d) Dealing with construction permits

Sol. (a) The Ease of doing Business index ranks countries against each other based on how the regulatory environment is conducive to business operation. Of the options given, the option (a), i.e. 'Maintenance of law and order' is not a sub index of the 'Ease of Doing Business Index.'

2018

1. Increase in absolute and per capita real GNP does not connote a higher level of economic development, if
(a) industrial output fails to keep pace with agricultural output.
(b) agricultural output fails to keep pace with industrial output.
(c) poverty and unemployment increase.
(d) imports grow faster than exports.

Sol. (c) Concepts of per capita income (per capita GDP or per capita NSDP) are not able to capture this aspect of development.

There may be a case wherein an increase in absolute and per capita GNP is **reflective of growth in income** of a small section of society and that majority of the population is poverty stricken and unemployed.

Multi-dimensional non-monetary social indicators are better reflectors of overall economic development in the Society.

2. Despite being a high saving economy, capital formation may not result in significant increase in output due to
(a) weak administrative machinery
(b) illiteracy
(c) high population density
(d) high capital-output ratio

Sol. (d)

Capital Output Ratio (ICOR) measures the percentage increase in capital formation required obtaining a percentage increase in GDP. Entrepreneurs, by investing their own savings and informally mobilising the savings of their friends and relatives contribute to the process of capital formation. These informal funding supplements the funds made available by the formal means of raising resources from banks, financial institutions and capital markets.

2017

1. Which of the following gives 'Global Gender Gap Index' ranking to the countries of the world?
(a) World Economic Forum
(b) UN Human Rights Council
(c) UN Women
(d) World Health Organization

Sol. (a) WEF is a Geneva based non-profit body set up in 1971.

2016

1. Which of the following is/are the indicators used by IFPRI to compute the Global Hunger Index Report?
1. Undernourishment 2. Child stunting
3. Child mortality

Select the correct answer using the code given below.
(a) 1 only (b) 2 and 3 only
(c) 1, 2 and 3 (d) 1 and 3 only

Sol. (c)

The IFPRI has its Headquarters situated in Washington, DC. The 4th indicator of this index is 'Acute malnutrition'.

2015

1. With reference to the Indian economy, consider the following statements:
1. The rate of growth of real Gross Domestic Product has steadily increased in the last decade.
2. The Gross Domestic Product at market prices (in rupees) has steadily increased in the last decade.

Which of the statements given above is/are correct?
(a) 1 only (b) 2 only
(c) Both 1 and 2 (d) Neither 1 nor 2

Sol. (b) Real GDP growth rate of India came down during the GFC in 2008-09. But as India did not face a recession, its nominal GDP has increased from 2005 to 2015.

2013

1. Economic growth in country X will necessarily have to occur if
(a) there is technical progress in the world Economy
(b) there is population growth in X
(c) there is capital formation in X
(d) the volume of trade grows in the world Economy

Sol. (c) Capital formation brings additional income/ production in the economy which enhances growth. Other choices do not lead to 'necessary' growth.

2. The national income of a country for a given period is equal to the
(a) Total value of goods and services produced by the nationals.
(b) Sum of total consumption and investment expenditure.
(c) Sum of personal income of all individuals.
(d) Money value of final goods and services produced.

Sol. (d) National income is the total value a country's final output of all new goods and services produced in one year

2012

1. The Multi-dimensional Poverty Index developed by Oxford Poverty and Human Development Initiative with UNDP support covers which of the following?
1. Deprivation of education, health, assets and services at household level
2. Purchasing power parity at national level
3. Extent of budget deficit and GDP growth rate at national level

Select the correct answer using the codes given below :
(a) 1 only (b) 2 and 3 only
(c) 1 and 3 only (d) 1, 2 and 3

Sol. (a) The multi-dimensional poverty index (MPI) bases its estimation on education (years of schooling and attendance in schools), health (child mortality and nutrition) and standard of living (electricity, sanitation, drinking water, flooring of the house, cooking fuel and asset ownership).

2011

1. Which of the following can aid in furthering the Government's objective of inclusive growth?
1. Promoting Self-Help Groups
2. Promoting Micro, Small and Medium Enterprises
3. Implementing the Right to Education Act

Select the correct answer using the codes given below:
(a) 1 only (b) 1 and 2 only
(c) 2 and 3 only (d) 1, 2 and 3

Sol. (d) The Government's objective of inclusive growth can be furthered by promoting self help groups, promoting micro, small and medium enterprises and implementing the right to education. This will improve employment opportunities, increase GDP etc.

2. Economic growth is usually coupled with
(a) Deflation (b) Inflation
(c) Stagflation (d) Hyperinflation

Sol. (b) Economic growth results in higher disposable income available with the consumers which increases the overall demand along with the supply available for the consumers. This increase in demand spurs inflation, which eventually becomes a necessary evil for a growing economy.

Previous Years' Mains Questions

1. Among several factors for India's potential growth, the savings rate is the most effective one. Do you agree? What are the other factors available for growth potential?

(2017 – 150 words, 10 marks)

2. What are the salient features of 'inclusive growth'? Has India been experiencing such a growth process? Analyze and suggest measures for inclusive growth.

(2017 – 250 words, 15 marks)

3. Comment on the challenges for inclusive growth which include careless and useless manpower in the Indi¬an context. Suggest measures to be taken for facing these challenges.

(200 words, 12.5 marks)(2016)

4. Capitalism has guided the world economy to unprecedented prosperity. However, it often encourages short-sightedness and contributes to wide disparities between the rich and the poor. In this light, would it be correct to believe and adopt capitalism for bringing inclusive growth in India? Discuss.

(2014 – 200 words, 12.5 marks)

5. Normally countries shift from agriculture to industry and then later to services, but India shifted directly from agriculture to services. What are the reasons for the huge growth-services vis-a-vis industry in the coun-try? Can India become a developed country without a strong industrial base? **(2014 – 200 words, 12.5 marks)**

2 Fiscal Policy and Taxation

(Mobilization of Resources)

2.1 : FISCAL POLICY

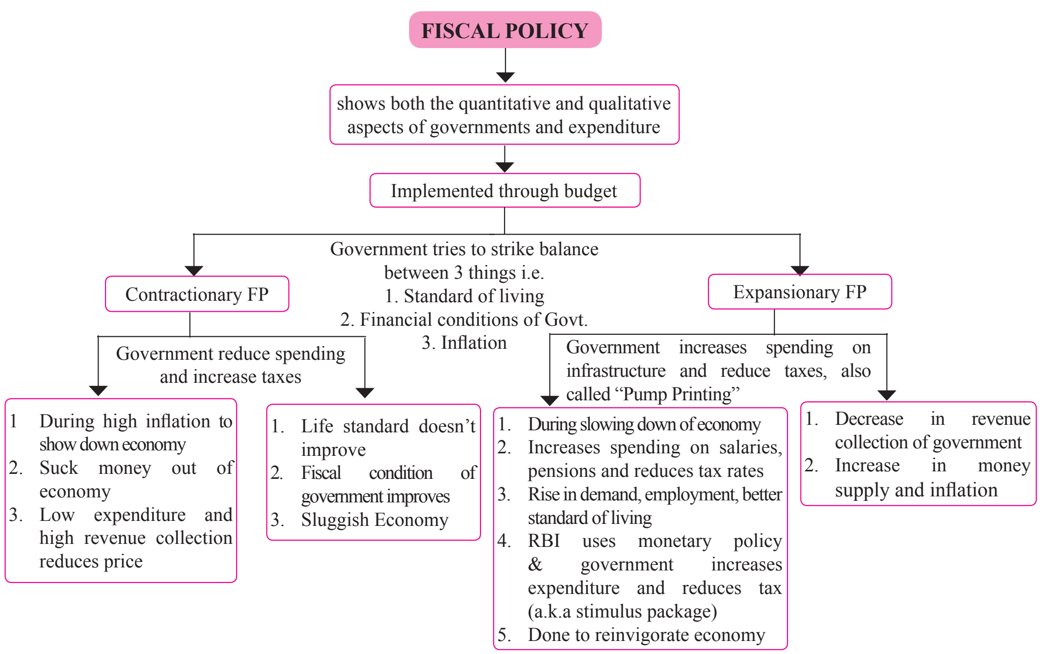
Fiscal Policy tells about both the quantitative and qualitative aspects of government's income and expenditure. Government implements its fiscal policy with the help of annual budget.

Types of Fiscal Policy

1. Contractionary Fiscal Policy

Government reduces spending on infrastructure, subsidies, etc. and increases taxes.

When inflation is too strong, the economy may need a slowdown. In such a situation the government can use fiscal policy to increase taxes to suck money out of the economy. Fiscal policy could also dictate a decrease in government spending and thereby decreases the money in circulation. Of course, the possible negative effects of such a policy in the long run could be a sluggish economy, less growth and high unemployment levels.



Mind Map 2.1

Contractionary Fiscal Policy has the following effects:

- The standard of living of people does not improve.
- The financial condition of the government improves.

Low expenditure and high revenue collection reduces money supply in the market and, therefore, may lead to a fall in price.

2. Expansionary Fiscal Policy

Government increases spending on infrastructure creation, salaries, pensions, etc. and reduces tax rates.

When an economy has slowed down, unemployment levels have increased, spending has reduced, and businesses are not making substantial profits. In such a scenario, the government follows expansionary fiscal policy, which leads to more funds with people and, consequently, rise in demand, investment, employment and output. However, any such increase in expenditure and decrease in revenue collection would also depend on the financial condition of the government. Pumping money into the economy by decreasing taxation and increasing government spending is known as "pump priming'. Thus, when the economy is slow, the RBI increases the money supply by exercising monetary policy and the government increases expenditure and reduces tax collection. This is called a stimulus package. In other words, a stimulus package is a package of economic measures put together by the government to stimulate a floundering economy. The objective of a stimulus package is to reinvigorate the economy and prevent or reverse a recession by boosting employment and spending.

Expansionary Fiscal Policy has the following effects:

- People's standard of living improves
- Financial condition of the government deteriorates
- Higher expenditure and reduced revenue collection increases money supply and may lead to inflation. While exercising the fiscal policy, the government strives to strike a balance between the above three factors. i.e. standard of living of people, financial conditions of government and inflation in the economy.

How the Budget is Made?

The budget is made through a consultative process involving the Ministry of Finance, NITI Aayog and spending ministries. The Budget Division of the Department of Economic Affairs in the Ministry of Finance is the nodal body responsible for producing the budget. The Finance Ministry issues guidelines on spending by various ministries. On the basis of these guidelines, various ministries present their demands. In September, the Budget Division issues a circular to all union ministries, states, union territories, autonomous bodies, departments, and the defence forces for preparing the estimates for the next year. After the ministries and departments send their demands, extensive consultations are held between the union ministries and the Department of Expenditure of the Finance Ministry. At the same time, the Department of Economic Affairs and the Department of Revenue meet the various interest groups such as farmers, businesspersons, etc. to take their views. After the pre-budget meetings, a final call on the tax proposals is taken by the Finance Minister. The proposals are discussed with the Prime Minister before the budget is finalized.

Budget - It is the Annual financial statement of income & expenditure of the government.

Every budget (e.g. 2020-21) contains three types of data:

1. Budgetary estimates (of the next year 2020-21)
2. Revised estimates (of the current year 2019-20)
3. Actual data (of the previous year 2018-19)

Revenue Budget

This part of the budget deals with income & expenditure of the revenue account of the government.

Revenue Expenditure

This expenditure of the government neither creates assets nor reduces liabilities. It is synonymous with maintenance, consumption and welfare. It includes Interest paid on loans taken (also called debt servicing), salaries and pension & provident fund contribution, subsidies, defence, account expenditure, law and order expenditure, expenditure on social service (poverty alleviation schemes) grants given by centre to states and other countries.

Revenue Receipts

These receipts neither create liabilities nor reduce assets.

Revenue Receipts are of two types:

Tax revenue receipts: It is of two types viz. direct tax revenue receipts and indirect tax revenue receipts.

Non Tax Revenue Receipts: It includes user charges, bills, penalties, profits and dividends from PSUs (the government is the largest shareholder of PSUs), Interest earned on loans given, grants which the government receives (both external (centre receives from World Bank and other countries) and internal (states receive from centre), service income from railways, advertisements and CISF giving protection to MNCs, etc.

Rev. Deficit = Rev. Exp. – Rev.Receipts

(If Rev. Exp > Rev.Receipts)

Rev. Surplus = Rev.Receipts – Rev. Exp

(If Rev. Exp < Rev. Receipts)

In India, we have Revenue deficit. Revenue deficit is not good as money is spent for consumption purposes. Incurring Revenue Deficit is considered a serious crime in management of fiscal policy by the government. Revenue Deficit implies that the government's tax collection is not up to the mark and its maintenance and consumption expenditure is huge. Therefore, revenue deficit is criticized and should be kept as low as possible. The best option is to have revenue surplus, but if that is not possible, then Revenue Deficit should be minimized. Government will fill the deficit with the money which could have been invested in productive areas.

Effective Revenue Deficit

GOCA is Grants for creation of Capital Assets. Revenue expenditure also includes all those grants which the centre gives to states and union territories. But some of these grants are used by states to create capital assets (though these assets are owned by the respective states & UTs and not the centre). As this part of the revenue expenditure contributes to the growth of the economy so it shouldn't be treated as unproductive in nature. The GOCA includes the Government of India grants to the states and the union territories for the implementation of centrally sponsored schemes (CSS).

Effective Revenue Deficit = Revenue Deficit – GoCA

Capital Budget

This part of the budget deals with receipt and expenditure of the capital account by the government.

Capital Expenditure

This expenditure either creates assets or reduces liabilities. It includes Loans given by centre, both internal (to states, PSUs, UTs) and external (to other countries, or purchase of sovereign bond), loan repayments, government expenditure on infrastructure creation, capital expenditure on defence e.g. purchase of arms, fighter jets from other countries. (comes under revenue as well as capital expenditure), other liabilities of government like repayment of all receipts generated by government e.g. PF liabilities.

Sovereign bond – It is debt security issued by a national government. It can be denominated in foreign currency or domestic currency. Because of default risk, they are offered at a discount. Less developed countries have difficulty issuing sovereign bonds denominated in their own currency & thus have to issue in foreign currency.

Capital Receipts

These government receipts either create liabilities or reduce assets. It is of two types: Debt creating Capital Receipts and Non Debt creating Capital Receipts.

Non debt Creating Capital Receipts include: Loan recovered from states and other countries, Disinvestment proceeds, etc. (Both of them reduce assets)

Debt creating Capital Receipts are:

Borrowings by the government both internal (such as RBI, SBI, LIC, etc.) and external (World Bank, Foreign governments) Raising of funds from public provident Fund (PPF) and small savings deposits, e.g. Indira Vikas Patra, Kisan Vikas Patra.

Few points to ponder

Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) – (Revenue Receipts + Non Debt creating capital receipts)

= borrowings of the Government

Budget Deficit = (Revenue Expenditure + Capital Expenditure) – (Revenue Receipts + Capital Receipts

= 0 (always equal to 0)

Primary Deficit = Fiscal Deficit – Interest Payments

Primary deficit tells us that out of total borrowings of the country, how much is used in interest payments (debt servicing) and how much is used for expenditure on the economy.

Budgetary Estimates of 2021-22

Revenue Receipts = 17.8 Lcr

Tax Rev Receipts = 15.4 Lcr

Non Tax Rev. Receipts = 24.3 Lcr

Revenue Expenditure = 26.3 Lcr

Interest Payments = 80.9 Lcr

Total Expenditure = 34.8 Lcr

Revenue Deficit = 11.4 Lcr (2.7% of GDP)

Fiscal Deficit = 15.0 Lcr (3.5% of GDP)

(Source Budget 2020-21)

All this data was given in Feb 2020, which was pre covid 19 and pre lockdown period.

Now because of the lockdown, government expenditure has increased and receipts have come down. Hence, revenue deficit and fiscal deficit will increase for 2020-21 as compared to the budgetary estimates. If the fiscal deficit is zero or surplus, it means the government is not having enough of capital expenditure and is earning more from the people by imposing more taxes.

Fiscal Deficit caused due to high capital expenditure is better than fiscal deficit caused due to high revenue expenditure as the government is investing in long term projects and not for consumption purposes.

But on the other hand, for a country like India, an undue focus on revenue deficits may be detrimental to equitable development. Human capital development initiatives which include schools, hospitals and also maintenance of assets, which are in the nature of revenue expenditure, are as important to improve productivity as buildings and roads. Thus, there is no qualitative difference in government's capital and revenue expenditure. The distinction is more artificial than real.

Deficit Financing

It is the process by which the government finances/ supports its deficit budget. In this process the government knows in advance that its total expenditure is going to be more than its income and hence follows such policies so that it can sustain the burden of the deficits proposed by it.

Means of Deficit Financing

Following are the means in order of their preference:-

(1) External aid/grants

(2) External borrowings

They should be cheaper and for the long term. It is considered better than internal borrowings due to two reasons: If the government borrows from external sources then the domestic banks don't have to lend to the government and can lend to the corporates. Hence crowding out of the corporates doesn't take place. External borrowings can be used by the government to finance its external expenditure

(3) Internal borrowings

To finance its deficit, the government borrows more amount from the banks and moreover it is borrowed at lower rate of interest (the government is considered most secure, so the rate of interest for it is the least). But to compensate this more amount lent at low rate of interest, the banks lend to corporates and retail borrowers at high rate of interest. Neither the corporates nor the private individuals are able to borrow from the banks at these rates. The corporates don't get funds for investment (it hampers the investment process in the country) leading to lower production which causes lower demand in the economy because there will be decrease in employment. Therefore, the economy stagnates or slows down which further decreases the tax collections and the total receipts and fiscal deficit increases further and we get caught in a vicious cycle.

(4) Printing new currency

It is the last resort for the government. RBI prints fresh currency and gives to the government and in return buys government bonds. It is also called **monetization of deficit or direct monetization** (OMOs are called indirect monetization because in OMOs, banks sell g-secs to RBI to get funds and then these funds are given to the government) or also called RBI purchasing g-secs in the primary market. **But the drawbacks are:**

(a) Government cannot go for the expenditures which are to be made in the foreign currency.

(b) It causes inflation.

(c) It brings pressure on the government to increase wages of government employees due to inflation which causes further printing of currency and further inflation hence the government is stuck in a vicious cycle.

(d) Moreover, it puts the government in a habit of wasteful expenditure, where the government thinks that whatever is the deficit, it will be able to fulfil it by asking the RBI to print new currency.

Drawbacks of High Fiscal Deficit

1. **Inflation :** Too much of government debt can lead to inflation and reduction in **real interest rates** (may becomes **negative** also if inflation is too high). (The interest which bank pays to us on demand deposits or time deposits is nominal interest rate, but if nominal interest rate is adjusted to inflation, we get real interest rate. Real interest rate is nominal interest rate minus inflation rate. Suppose the bank is giving us 6% interest on fixed deposits of one year, but if the inflation rate is 4% in that year then my actual benefit (real interest rate) by keeping money in the bank is only 2%) People will withdraw deposits from the banks. It might prompt people to invest more in gold and real estate, thereby accentuating the problem of poor economic liquidity and black money. Banks would be left with very less money to lend for investment. Investment would come down and hence growth also.

   To counter inflation, RBI will have to increase the interest rates. The corporates would not borrow at this rate and overall investment in the economy would come down.

2. **Intergenerational parity will be hurt** It will be hurt as future generations will have to pay increased taxes to return the borrowings of the current government.

3. It may cause **Balance of Payment crisis.** Due to high fiscal deficit, public debt of the country will increase. It will cause downgrading of sovereign credit ratings by the credit rating agencies. Loss of investor confidence will not only reduce FDI/FII in India but FDI/FPI may move out of the country. It will make future borrowing expensive and also cause depreciation of rupee with respect to dollar. It will make imports more expensive and further fuel inflation. Moreover, due to depreciation, the interest payments will increase and Current Account Deficit will increase which may cause BoP issues.
4. **Crowding out of corporates:** As more money is lent to government, the banks are left with less funds to lend to corporates. This is called crowding out of corporates. Due to crowding out, there will be slower industrial and capital asset growth and potential loss of employment, which can cause growth to come down in future High inflation and hence real interest rate would become negative (effect of negative interest rate explained in inflation chapter).
5. **Fiscal repression of commercial banks:** When the government borrows more, it forces PSBs (Public Sector Banks) to purchase more of Government Securities (G-secs). When a commercial bank invests more in G-secs (where it earns lesser interest than commercial loans), it reduces the funds available with the banks which could have been lent to the private sector and affects profitability of the banks.

   While Government borrowing is necessary to stimulate growth and aggregate demand by spending in welfare measures and capital asset development, high debt-to-GDP ratio isn't good for long term macroeconomic stability of the country.

   Typically, for a developing economy, where private enterprises may be weak and governments may be in a better state to invest, fiscal deficit could be higher than in a developed economy.

   Here, governments also have to invest in both social and physical infrastructure upfront without having adequate avenues for raising revenues.

Fiscal Consolidation

Reduction in fiscal deficit over a period of time is called fiscal consolidation.

Fiscal Slippage

When the fiscal deficit for a year becomes more than the targeted fiscal deficit for that year, it is called fiscal slippage, e.g. Fiscal deficit target for 2019-20 was 3.3% of the GDP, but the year ended up with 4.6% fiscal deficit.

Fiscal Glide Path

It is the path the government takes to fulfil the fiscal targets it sets up for itself.

How much of Fiscal deficit is Right?

Fiscal Deficit is bridged by market borrowings and central bank printing fresh currency, if necessary. To a limited extent, Fiscal Deficit is important as the Government's ability to help growth and welfare increases. Government can always return the loans when its revenues improve due to tax buoyancy (discussed in the Taxation chapter). However, Fiscal Deficit becomes problematic and even destabilizing when it overshoots a rational threshold. Sovereign debt crisis in Greece and the fiscal woes of the USA are the result of unsustainable high debt and borrowing. Therefore, moderation of fiscal deficit is important. Large and persistent fiscal deficits are a cause of concern, as they pose several risks. Fiscal deficits may cause macroeconomic instability by inflating the economy as money supply rises. Corporate sector is crowded out — they are left with inadequate funds in the markets as the government borrowing requirements increase. Added to that, interest rates will be high as there is pressure on the available money in the market.

If the funding route is through RBI monetization, it means inflation and instability. Inflation may mean less savings, less investment and eventually it hurts the sustainability of high growth. Large deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term to cover the heavy burden of internal debt. It means, as the FRBM Act says , inter-generational parity is hurt if debt mounts as future generations will have to pay higher taxes to help the government repay-the debt. Government liabilities- interest payments- increase and there is far less for development. There can be a BOP crisis as FDI/FII (Foreign Direct Investment/Foreign Institutional Investment) inflows may decrease because the credit rating of the country can come down because of high FD. The above situation is good in normal times, but in abnormal times like slowdown or recession, the FD may be allowed to go up as the stimulus package is required from the govt side to get the economy out of the crisis.

Mains Model Answers by IAS Toppers

The public expenditure management is a challenge to the Government of India in context of budget making during the post liberalization period. Clarify it. (2019 – 250 words / 15 marks)

Public expenditure management (PEM) is the approach of prudent use of government financial resources so as to achieve good governance. It focuses on outcomes and sees expenditures as a means to produce outputs which are needed to achieve desired outcomes.

Various challenges faced by the government with regard to PEM

- Global economic shocks: such as the 2008 global economic meltdown, fed tapering, crude oil prices, trade wars, etc. have much more effect on the domestic economy due to an increasingly integrated global economy.
- Less capital expenditure: Budget's capital expenditure is essential to ensure inter-generational equity and competitiveness of the economy.
- Banking sector: It is facing issues such as Twin-Balance sheet crisis, balance between disinvestment or bank consolidation, NPA crisis, etc.
- Low Tax to GDP ratio: which has risen from around 7% in 1990 to 10% in 2019 which is not commensurate with the economic growth trajectory of India.
- Populist tendencies: This leads to unproductive spending of the scarce government resources. e.g. giving tax sops, farm loan waivers in the pre-election period.
- Managing public debt: It is essential to ensure that the burden of the current generation's needs doesn't fall on the next generation.
- Trade deficit: It should be reduced in order to have healthier global trade and improve market competitiveness.
- Containing inflation: It is one of the most important objectives of monetary policy which is also impacted by the revenue and expenditure policies of the government.

Measures taken by the government for effective PEM

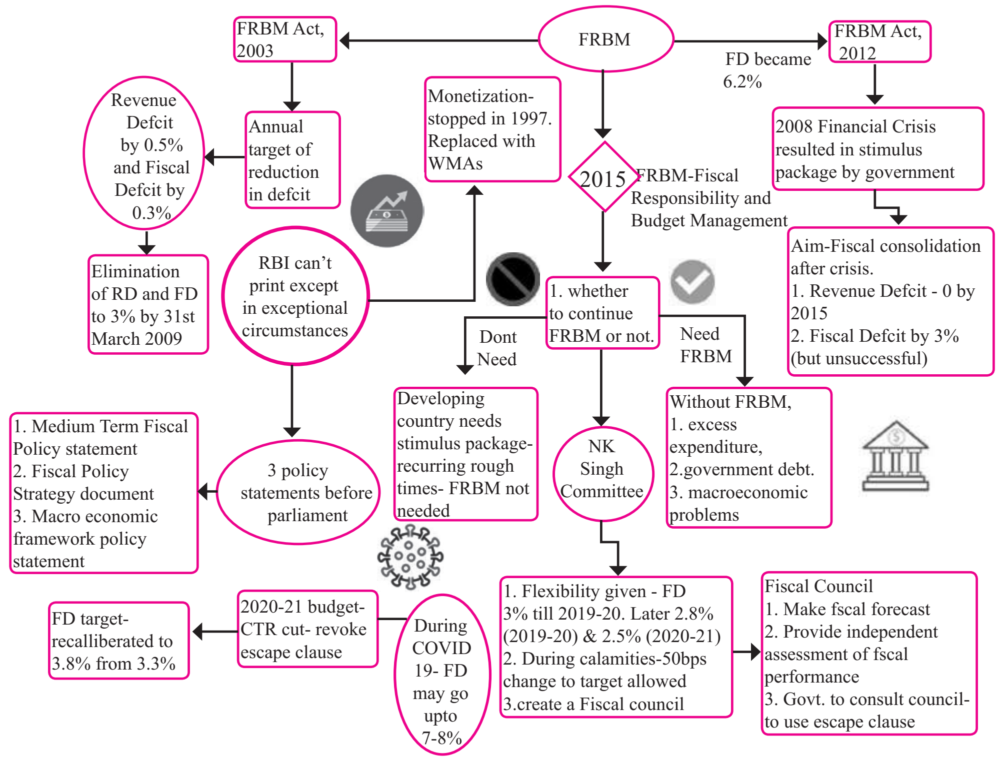
- Monetary policy framework: Inflation targeting by the Monetary Policy Committee has helped in price stability
- FRBM (Amendment) Act: Government has targeted to reduce the fiscal deficit gradually and stabilize it by 2023 to 2.5%.
- Removing Plan/Non-plan distinction: It will help in allocation of more resources for creation of capital assets which in turn will help in improving the efficiency of the economy.
- Deepening of Fiscal Federalism: More tax revenue has been devolved to states from the divisible tax pool.
- Public Fund Management System: is an online platform to monitor the progress of government schemes

Prudent public finance management would be key to unlocking the growth potential of the Indian economy.

FRBM Act (Fiscal Responsibility and Budget Management Act), 2003

In the year 2000, the fiscal situation of the government of India had worsened and the fiscal deficit reached 6% of GDP. It was argued that a legislative provision that is applicable to all governments – present and future – is likely to be effective in keeping the deficits under control. The government enacted the FRBM Act 2003, which became effective from July 2004. It had the following features:

1. Annual targets of reduction in deficits, government borrowings and debt were given to the government (centre as well as states).
2. Government will annually reduce the Revenue Deficit by 0.5% and Fiscal Deficit by 0.3% beginning from 2004-2005.
3. Elimination of Revenue Deficit and reduction of Fiscal Deficit to 3% by 31st March 2009.
4. RBI can't print money to lend to the government. Only in times of calamities can the RBI print money to give to the centre (Monetization of deficit was stopped through this act. Monetization was earlier stopped in 1997 and was replaced with WMAs. But the legal status was accorded with this act) .
5. The govt. will also before the parliament, three policy statements in each financial year.
   (a) Medium Term Fiscal Policy statement.
   (b) Fiscal Policy Strategy document
   (c) Macro economic framework policy statement



Mind Map 2.2

FRBM Amendment Act, 2012

Starting from 2004-05, the centre as well as the states were achieving the annual targets given by the Act. The central government had managed to cut the fiscal deficit to 2.7% of GDP and revenue deficit to 1.1% of GDP in 2007–08. However, the targets were not met. The global financial crisis (2007-08) led the government to infuse resources in the economy as the fiscal stimulus in 2008. Government gave stimulus packages like loan waiver, decreasing interest rates, decreasing tax rates and increased government spending to get India out of slowdown. Hence revenue deficit & Fiscal Deficit increased. Fiscal Deficit became 6.2%.

Therefore, fiscal targets had to be postponed temporarily in view of the global crisis.

But later because of the stimulus package, Indian economy recovered from the slowdown. India's GDP growth in 2007-08 was 9%, 2008-09 was 6.7%, 2009-10 was 8.5%, 2010-11 was 8.4% and for 2011-12 was 6.5%. So, government decided to focus on fiscal consolidation again (Fiscal Deficit of 2011-12 was 5.9%). Therefore, FRBM Act was amended in 2012 and new targets were given.

As per the amendments, effective revenue deficit (instead of revenue deficit) will be brought to 0% by and fiscal deficit to 3% by 31st March, 2015. But when the government found it difficult to achieve these numbers, it further pushed the targets. By finance act of 2015-16, the targets were moved forward. The effective revenue deficit will be brought to 0% and fiscal deficit to 3% by 31st March, 2018. (Source: The Hindu).

Rethinking on FRBM Act

After nearly twelve years into running of the FRBM (2003) legislation, there was a big debate in 2015, on whether India should continue with a fiscal deficit target or not. One group argued that in a developing country, the government has to make a lot of expenditure and an upper limit will reduce government involvement. Moreover, an economy goes through various ups and downs.

Banks and financial institutions fund business and others, and it is that credit money which drives the economy. If, for some reason including reasons like; lack of business confidence or rising NPAs, the bank credit to the economy does not adequately grow, economic growth will suffer due to lack of adequate money. That is when the Budget needs to step in, to pump money into the economy by incurring a deficit, and, for the purpose, borrow the money lying with banks or even by printing more money, if that is needed.

In the downtime of the economy, the government should give stimulus packages otherwise the slowdown can get converted to recession and recession to depression. But the fixed fiscal deficit target given by the FRBM Act, limits the scope of fiscal stimulus (Fiscal stimulus package will increase government's expenditure and decrease its income, hence will increase revenue deficit and fiscal deficit). The opposite group countered that loosening of the target will lead to excess expenditure, government debt, inflation and several other macroeconomic problems besides creating intergenerational inequality. The government set up NK Singh Committee to suggest a way out and review the FRBM Act. Specifically, the Committee has to make suggestions on a commonly raised idea that there should be a fiscal deficit range rather than a fixed target (like 3% of GDP). Similarly, the committee should suggest changes required in FRBM in the context of rising global uncertainties.

NK Singh Committee on FRBM Act

The committee was set up in May, 2016 to review the FRBM Act and it submitted its report in January 2017.

The Committee has suggested that a rule based fiscal policy by limiting government debt, fiscal deficit and revenue deficits to certain targets are good for fiscal consolidation in India. The following are its recommendations:

(i) It gives flexibility to the Centre on fiscal consolidation (fiscal consolidation means a decrease in fiscal deficit).It allows fiscal expansion for the near term by maintaining a fiscal deficit to GDP ratio of 3% till 2019-20. After this, it recommends a reduction in fiscal deficit targets viz. 2.8% for 2020-21 and 2.5% for 2022-23.

(ii) It recommends an escape clause which would allow the government to skip the fiscal deficit target for a particular year in case of certain situations like national calamity, war, structural reforms in the economy etc. In the above cases, the fiscal deficit can exceed by 50bps (0.5%) as compared to the target.

(iii) Existing FRBM Act should be scrapped and a new Debt and Fiscal Responsibility Act be adopted.

(iv) It has also suggested the creation of a Fiscal Council which will:

   1. Prepare *multi-year fiscal forecasts* for the central and state governments.
   2. Provide an *independent assessment of the central government's fiscal performance.*
   3. Government must also consult the council before invoking escape clauses.

(v) Instead of fiscal and revenue deficit numbers, the government should focus on public debt as a proportion to GDP and should bring it to 60% (40% for centre and 20% for the states) by 2023 (in 2016 it was 68%(44% centre 24% all states put together). This is a simple measure of insolvency, also used by rating agencies.

Relaxation of FRBM norms in the past

Most significant one was in 2008-09 – during the global financial crisis, when the Centre resorted to fiscal stimulus – lead to fiscal deficit climbing to 6.2% of GDP, from a budgeted goal of 2.7%.

Simultaneously, the deficit goals for the States too were relaxed to 3.5% of GSDP for 2008-09 and 4% of GSDP for fiscal 2009-10.

In the recent Union Budget for 2020-21, the reductions in corporate tax(in 2019) was considered as structural reforms so as to trigger the escape clause - fiscal deficit target for 2019-20 was recalibrated to 3.8%, from the earlier 3.3%(budgetary estimates) (B.E.).

If we talk about the current scenario, B.E for fiscal deficit for 2018-19 was 3.3% but the actual data shows it to be 3.4%. B.E for 2019-20 was 3.3% (contrary to what NK Singh Committee had recommended) and the fiscal glide path expected a FD for 2020-21 to be 3%. But the actual data for 2019-20 gives the fiscal deficit at 4.6%. Similarly, the BE for 2020-21 for FD was 3.3% but seeing the current scenario after Covid19, it is expected to go around 7-8%.

So all calculations and recommendations have gone for a toss and we will have to start afresh after Covid19 is over and will have to recalibrate our projections about fiscal deficit.

FRBM Act and Covid-19

The Act allows the government to exceed the annual fiscal deficit target under extraordinary situations like national security, national calamity.

Due to COVID-19 pandemic, the current circumstances would be apt for suspending both the Centre's and States' fiscal deficit targets.

This would allow both the Union government and States to undertake the much needed increases in expenditure to meet the extraordinary circumstances.

Independent Fiscal Council

In India, two expert committees have advocated the institution of such a council in recent years.

In 2017, the N.K. Singh committee on the review of fiscal rules set up by the finance ministry suggested the creation of an independent fiscal council that would provide forecasts and advise the government on whether conditions exist for deviation from the mandated fiscal rules.

In 2018, the D.K. Srivastava committee on fiscal statistics established by the National Statistical Commission (NSC) also suggested the establishment of a fiscal council that could coordinate with all levels of government to provide harmonized fiscal statistics across governmental levels and provide an annual assessment of overall public sector borrowing requirements.

These recommendations follow similar recommendations from the 13th and 14th finance commissions, which also advocated the establishment of independent fiscal agencies to review the government's adherence to fiscal rules, and to provide independent assessments of budget proposals.

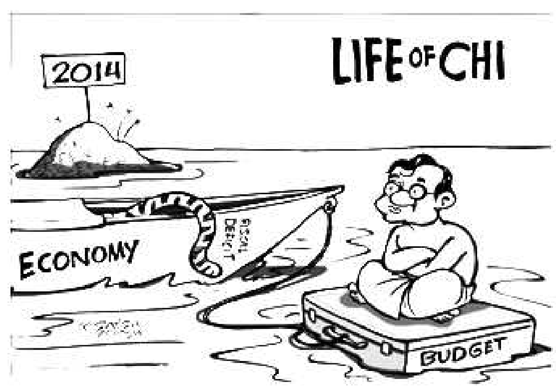
Functions of Independent Fiscal Council

- Prepare multi-year fiscal forecasts for the central and state governments.
- Define a sustainable level of public debt.
- Provide an independent assessment of the central government's borrowing & fiscal performance.
- Government must also consult the council before flouting fiscal deficit targets.

Advantages of an Independent Fiscal Council (IFC)

- IFC's evaluation of budget announcements & forecasts would indicate how realistic government projections are. This would be a check on competitive populism in Indian polity and would increase financial accountability of the government to the Parliament.
- An institutional mechanism for sound fiscal practices will bring in transparency, instil confidence among domestic & foreign investors and improve policy outcomes.
- It will promote the culture of proper disclosures and good accounting practices within the Govt.
- Most fiscal councils across the world are able to discipline lawmakers through 'comply or explain' obligations—requiring governments to at least explain the divergence from the fiscal council's views. International experience suggests that a fiscal council improves the quality of debate on public finance, and that, in turn, helps build public opinion favourable to fiscal discipline.
- An institutionalized fiscal council would enhance cooperation with the Finance Commission and GST Council.

According to the International Monetary Fund (IMF), IFCs are now an indispensable part in the design of fiscal frameworks aimed at guiding fiscal policymakers' discretion. An independent fiscal council can bring about much needed transparency and accountability in fiscal processes across the federal polity. With a complex polity and manifold development challenges, India needs institutional mechanisms for prudent fiscal practices.



Extra Budgetary Borrowings

One of the leading and interesting trends about the government budget is that extra budget are borrowings not shown in the budget. These borrowings may be done to finance some of the budgeted schemes like food subsidy and may be done by government owned entities like the Food Corporation of India. If these items are also included, the fiscal deficit of the government may shoot up. These borrowings made by the government owned entities that are effectively becomes the debt of the government are known as extra budget borrowings or resources. They are also known as off-budget resources. Both the centre and states are making such borrowings.

What are extra budgetary borrowings?

According the budget document, "Extra budgetary resources (EBRs) are those financial liabilities that are raised by Public Sector Undertakings for which repayment of entire principal and interest is done from Government budget,"

Such borrowings are made by state-owned firms to fund government schemes but are not part of the official budget calculations.

Extra budget borrowing is excluded from the fiscal deficit calculations, but at the same time, is ***added to the total debt of the government.***

In recent years, several CPSUs have raised resources from the market by issuing Government of India-Fully Serviced Bonds (GoIFSB) for which the repayment of both principal and interest is to be done from the Budget.

This means that though the borrowing is not a part of the consolidated fund of India, the interest payment for such borrowings are made out of the consolidated fund.

The borrowings are made through Government of India fully serviced bonds and NSSF Loans)

As per the government data, at end-March 2019, total outstanding liabilities on account of EBRs were 0.5 per cent of GDP and it is expected that by end-March 2020 they may rise to 0.7 per cent of the GDP.

Use of the Extra Budgetary Borrowings

Several budgets announced schemes are financed out of extra budget borrowings. These borrowings are done by the public sector entities that are administering the schemes. In the past, schemes like the Pradhan Mantri Krishi Sinchayee Yojana (PMKSY), Deen Dayal Upadhayay Gram Jyoti Yojana (DDUGJY), Swachh Bharat Mission (SBM), Pradhan Mantri Awas Yojana (PMAY), etc. were financed out of extra budget borrowings.

Main entities that have borrowed are FCI, National Highway Authority of India, National Bank for Agriculture and Rural Development (NABARD), which has borrowed for both rural development and irrigation projects. Similarly, Housing and Urban Development Corporation (HUDCO) for housing projects and Rural Electrification Corporation (REC) for electrification projects have also added to the extra budget borrowings.

In the same way, several state entities have also made extra budget borrowings. An interesting example is the Kerala government owned KIIFB that borrowed through issuing Rupee Denominated Bonds.

CAG on Off Budget Expenditure

The Comptroller and Auditor General of India has raised concern about rising off budget borrowings. "Government has increasingly resorted to off-budget financing for revenue as well as capital spending. In terms of revenue spending, off-budget financing was used for covering deferring fertilizer arrears/bills through special banking arrangements; food subsidy bills/arrears of FCI through borrowings and for implementation of irrigation scheme (AIBP) through borrowings by NABARD under the Long Term Irrigation Fund (LTIF)." – CAG.

"In terms of capital expenditure, off budget financing of railway projects through borrowings of the IRFC and financing of power projects through the PFC are outside the budgetary control,"- the CAG observed.

Ways and Means Advances (WMAs)

The Reserve Bank of India gives temporary loan facilities to the centre and state governments as a banker to government. This temporary loan facility is called Ways and Means Advances (WMA).

They aren't a source of finance per se. Section 17(5) of the RBI Act, 1934 authorises the central bank to lend to the Centre and state governments subject to their being repayable "not later than three months from the date of the making of the advance".

The WMA scheme for the Central Government was introduced on April 1, 1997, after putting an end to the four-decade old system of ad hoc (temporary) Treasury Bills to finance the Central Government deficit.

The WMA scheme was designed to meet temporary mismatches in the receipts and payments of the government. This facility can be availed by the government if it needs immediate cash from the RBI. WMA is not a security as it is not tradable.

Under the WMA system, the Reserve Bank extends short-term advances up to the pre-announced half-yearly limits, fully payable within three months. Interest rate for WMA is currently charged at the repo rate. The limits for WMA are mutually decided by the RBI and the Government of India.