GS SCORE

Abridged

ECONOMIC SURVEY

2016-17

with

Technical Terms
Supplementary Readings
Probable Questions

For Civil Services Examination

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Objective

Excerpts from Economic Survey with Practice Questions

The following chapters contain some of the most important facts and analysis from the economic survey.

The technical Terms in respective chapters alongwith supplementary readings have been added to give a better understanding of the topics.

We have also provided questions at the end of each chapter for your revision. Some answers you may be able to find in the chapter itself. Whereas some questions would have a theme from survey, but may also ask about additional facts and concepts. This will help you to prepare for overall Indian economy portion from paper 3. We hope you would find this useful and practise hard to utilize it in proper manner.

All the best !!!

PREFACE

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1 ECONOMIC OUTLOOK AND POLICY CHALLENGES

Context

The Indian Economy has sustained a macro-economic environment of relatively lower inflation, fiscal discipline and moderate current account deficit coupled with broadly stable rupee-dollar exchange rate.

As per the advance estimates released by the Central Statistics Office, the growth rate of GDP at constant market prices for the year 2016-17 is placed at 7.1 per cent, as against 7.6 per cent in 2015-16.This estimate is based mainly on information for the first seven to eight months of the financial year. Government final consumption expenditure is the major driver of GDP growth in the current year.

This year has been marked by several historic economic policy developments. On the domestic side, a constitutional amendment paved the way for the long-awaited and transformational goods and services tax (GST) while demonetisation of the large currency notes signaled a regime shift to punitively raise the costs of illicit activities. On the international front, Brexit and the US elections may herald a tectonic shift, forebodingly laden with darker possibilities for the global, and even the Indian, economy.

Each had impact on the Indian economy which have been analysed in the following chapter.

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A radical governance-cum-social engineering measure was enacted on November 8, 2016. The two largest denomination notes, Rs 500 and Rs 1000-together comprising 86 percent of all the cash in circulation-were "demonetised" with immediate effect, ceasing to be legal tender except for a few specified purposes.

The aim of the action was fourfold: to curb corruption, counterfeiting, the use of high denomination notes for terrorist activities, and especially the accumulation of "black money", generated by income that has not been declared to the tax authorities. The action followed a series of earlier efforts to curb such illicit activities, including the creation of the Special Investigation Team (SIT) in the 2014 budget, the Black Money Act, 2015; the Benami Transactions Act of 2016; the information exchange agreement with Switzerland, changes in the tax treaties with Mauritius and Cyprus, and the Income Disclosure Scheme.

Beyond these headline reforms were other less-heralded but nonetheless important actions. The government enacted a package of measures to assist the clothing sector that by virtue of being export-oriented and

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labour-intensive could provide a boost to employment, especially female employment. The National Payments Corporation of India (NPCI) successfully finalized the Unified Payments Interface (UPI) platform. By facilitating inter-operability it will unleash the power of mobile phones in achieving digitalization of payments and financial inclusion, and making the "M" an integral part of the government's flagship "JAM"-Jan Dhan, Aadhar, and Mobile- initiative. Further FDI reform measures were implemented, allowing India to become one of the world's largest recipients of foreign direct investment.

These measures cemented India's reputation as one of the few bright spots in an otherwise grim global economy. India is not only among the world's fastest growing major economies, underpinned by a stable macro-economy with declining inflation and improving fiscal and external balances.

Future reforms need to consider three major challenges: Reducing Inefficient redistribution," strengthening state capacity in delivering essential services and regulating markets, and dispelling the ambivalence about protecting property rights and embracing the private sector.

The central government alone runs about 950 central sector and centrally sponsored schemes and sub-schemes which cost about 5 percent of GDP. Restructuring it will require efforts and time and even then limited results could be expected.

Competitive federalism has been a powerful agent of change in relation to attracting investment and talent; it has been less in evidence in relation to essential service delivery.

The improvement of the Public Distribution System (PDS) in Chhattisgarh, the incentivization of agriculture in Madhya Pradesh, reforms in the power sector in Gujarat which improved delivery and cost recovery, the efficiency of social programs in Tamil Nadu, and the recent use of technology to help make Haryana kerosene-free.

But on health and education there are insufficient instances of good models that can travel widely within India and that are seen as attractive political opportunities. Competitive populism needs a counterpart in competitive service delivery.

Trade as Engine of Growth

Given that India's growth ambitions of 8-10 percent require export growth of about 15-20 percent, any serious retreat from openness on the part of India's trading partners would jeopardize those ambitions.

For India, three external developments are of significant consequence. In the short run, the change in the outlook for global interest rates as a result of the US elections and the implied change in expectations of US fiscal and monetary policy will impact on India's capital ?ows and exchange rates. Markets are factoring in a regime change in advanced countries, especially US macroeconomic policy, with high expectations of fiscal stimulus.

Second, the medium-term political outlook for globalisation and in particular for the world's "political carrying capacity for globalisation" may have changed in the wake of recent developments. In the short run a strong dollar and declining competitiveness might exacerbate the lure of protectionist policies.

Third, developments in the US, especially the rise of the dollar, will have implications for China's currency and currency policy. If China is able to successfully re-balance its economy, the spill over effects on India and the rest of the world will be positive.

India's growth and its compatibility to resistance to globalization

From India's perspective, the political carrying capacity for globalisation is relevant not just for goods but also services. The world's service exports-GDP ratio is about 6.1 percent. If India grows rapidly on the

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back of dynamic services exports, the world's service exports-GDP ratio will increase by 0.5 percentage points-which would be a considerable proportion of global exports. Put differently, India's services exports growth will test the world's globalisation carrying capacity in services. Responses could take not just the form of restrictions on labour mobility but also restrictions in advanced countries on outsourcing.

It is possible that the world's carrying capacity will actually be much greater for India's services than it was for China's goods. After all, China's export expansion over the past two decades was imbalanced in several ways: the country exported far more than it imported; it exported manufactured goods to advanced countries, displacing production there, but imported goods (raw materials) from developing countries; and when it did import from advanced economies, it often imported services rather than goods. As a result, China's development created relatively few export-oriented jobs in advanced countries, insufficient to compensate for the jobs lost in manufacturing - and where it did create jobs, these were in advanced services (such as finance), which were not possible for displaced manufacturing workers to obtain.

In contrast, India's expansion may well prove much more balanced. India has tended to run a current account deficit, rather than a surplus; and while its service exports might also displace workers in advanced countries, their skill set will make relocation to other service activities easier; indeed, they may well simply move on to complementary tasks, such as more advanced computer programming in the IT sector itself. On the other hand, since skilled labour in advanced economies will be exposed to Indian competition, their ability to mobilize political opinion might also be greater. In sum, the political backlash against globalisation in advanced countries, and China's difficulties in rebalancing its economy, could have major implications for India's economic prospects .They will need to be watched in the year - and decade - ahead.

Developments during 2016-17

Real GDP growth in the first half of the year was 7.2 percent, on the weaker side of the 7.0-7.75 per cent projection in the Economic Survey 2015-16 and somewhat lower than the 7.6 percent rate recorded in the second half of 2015-16.

The main problem was fixed investment, which declined sharply as stressed balance sheets in the corporate sector continued to take a toll on firm's' spending plans. On the positive side, the economy was buoyed by government consumption, as the 7th Pay Commission salary recommendations were implemented.

The **major highlights of the sectoral growth outcome** of the first half of 2016-17 were:

(i) Moderation in industrial and nongovernment service sectors;

(ii) The modest pick-up in agricultural growth on the back of improved monsoon; and

(iii) Strong growth in public administration and defence services

The **Consumer Price Index (CPI)-** New Series in?ation, which averaged 4.9 per cent during April-December 2016, has displayed a downward trend since July when it became apparent that kharif agricultural production in general, and pulses in particular would be bountiful. The decline in pulses prices has contributed substantially to the decline in CPI in?ation which reached 3.4 percent at end-December.

The second distinctive feature has been the **reversal of WPI inflation,** from a low of (-) 5.1 percent in August 2015 to 3.4 percent at end-December 2016.

The outlook for the year as a whole is for CPI in?ation to be below the RBI's target of 5 percent, a trend likely to be assisted by demonetisation.

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External Sector

The current account deficit has declined to reach about 0.3 percent of GDP in the first half of FY 2017. Foreign exchange reserves are at comfortable levels, having have risen from around US$350 billion at end-January 2016 to US$ 360 billion at end-December 2016 and are well above standard norms for reserve adequacy.

In part, surging net FDI in flows, which grew from 1.7 percent of GDP in FY2016 to 3.2 percent of GDP in the second quarter of FY2017, helped the balance-of-payments.

The trade deficit declined by 23.5 per cent in April-December 2016 over corresponding period of previous year. During the first half of the fiscal year, the main factor was the contraction in imports, which was far steeper than the fall in exports. But during October-December, both exports and imports started a long-awaited recovery, growing at an average rate of more than 5 per cent.

The improvement in exports appears to be linked to improvements in the world economy, led by better growth in the US and Germany.

The net services surplus declined in the first half, as software service exports slowed and financial service exports declined. Net private remittances declined by $4.5 bn in the first half of 2016- 17 compared to the same period of 2015-16, weighed down by the lagged effects of the oil price decline, which affected in?ows from the Gulf region.

Fiscal Performance

Trends in the fiscal sector in the first half have been unexceptional and the central government is committed to achieving its fiscal deficit target of 3.5 percent of GDP this year. Excise duties and services taxes have benefited from the additional revenue measures introduced last year.

The most notable feature has been the over-performance of excise duties in turn based on buoyant petroleum consumption: real consumption of petroleum products (petrol) increased by 11.2 percent during April-December 2016 compared to same period in the previous year.

Indirect taxes, especially petroleum excises, have held up even after demonetisation in part due to the exemption of petroleum products from its scope.

Non-tax revenues have been challenged owing to shortfall in spectrum and disinvestment receipts but also to forecast optimism; the stress in public sector enterprises has also reduced dividend payments.

The consolidated deficit of the states has increased steadily in recent years, rising from 2.5 percent of GDP in 2014-15 to 3.6 percent of GDP in 2015-16, in part because of the UDAY scheme.

Economic Outlook

Demonetization

Demonetisation affects the economy through three different channels. It is potentially:

- An aggregate demand shock because it reduces the supply of money and affects private wealth, especially of those holding unaccounted money;
- An aggregate supply shock to the extent that economic activity relies on cash as an input (for example, agricultural production might be affected since sowing requires the use of labour traditionally paid in cash); and

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- An uncertainty shock because economic agents face imponderables related to the magnitude and duration of the cash shortage and the policy responses (perhaps causing consumers to defer or reduce discretionary consumption and firms to scale back investments).

Impact on GDP

Consumer spending and two-wheelers, as the best indicator of both rural and less af?uent demand;

- Real credit growth; and
- Real estate prices

Contrary to early fears, as of January 15, 2017 aggregate sowing of the two major rabi crops-wheat and pulses (gram)--exceeded last year's planting by 7.1 percent and 10.7 percent, respectively .

Recorded GDP growth in the second half of FY 2017 will understate the overall impact because the most affected parts of the economy-informal and cash-based- are either not captured in the national income accounts or to the extent they are, their measurement is based on formal sector indicators.

For example, informal manufacturing is proxied by the Index of Industrial Production, which includes mostly large establishments. So, on the production or supply side, the effect on economic activity will be underestimated.

Outlook for 2017-18

India's exports appear to be recovering, based on an uptick in global economic activity. This is expected to continue in the aftermath of the US elections and expectations of a fiscal stimulus.

The IMF's January update of its World Economic Outlook forecast is projecting an increase in global growth from 3.1 percent in 2016 to 3.4 percent in 2017, with a corresponding increase in growth for advanced economies from 1.6 percent to 1.9 percent. Given the high elasticity of Indian real export growth to global GDP, exports could contribute to higher growth next year, by as much as 1 percentage point.

International oil prices are expected to be about 10-15 percent higher in 2017 compared to 2016, which would create a drag of about 0.5 percentage points. On the other hand, consumption is expected to receive a boost from two sources: catch-up after the demonetisation-induced reduction in the last two quarters of 2016-17; and cheaper borrowing costs, which are likely to be lower in 2017 than 2016 by as much as 75 to 100 basis points. As a result, spending on housing and consumer durables and semi-durables could rise smartly.

Since no clear progress is yet visible in tackling the twin balance sheet problem, private investment is unlikely to recover significantly from the levels of FY 2017. Some of this weakness could be offset through higher public investment, but that would depend on the stance of fiscal policy next year, which has to balance the short-term requirements of an economy recovering from demonetisation against the medium-term necessity of adhering to fiscal discipline-and the need to be seen as doing so.

Putting these factors together, we expect real GDP growth to be in the 6¾ to 7½ percent range in FY 2018. Even under this forecast, India would remain the fastest growing major economy in the world.

There are three main downside risks to the forecast. First, the extent to which the effects of demonetisation could linger into next year, especially if uncertainty remains on the policy response. Currency shortages also affect supplies of certain agricultural products, especially milk (where procurement has been low), sugar (where cane availability and drought in the southern states will restrict production), and potatoes and onions (where sowings have been low). Vigilance is essential to prevent other agricultural products becoming in 2017-18 what pulses were in 2015-16.

Fiscal Outlook

The fiscal outlook for the central government for next year will be marked by three factors. First, the increase in the tax to GDP ratio of about 0.5 percentage points in each of the last two years, owing to the oil windfall will disappear. In fact, excise-related taxes will decline by about 0.1 percentage point of GDP, a swing of about 0.6 percentage points relative to FY2017.

Second, there will be a fiscal windfall both from the high denomination notes that are not returned to the RBI and from higher tax collections as a result of increased disclosure under the Pradhan Mantra Garib Kalyan Yojana (PMGKY). Both of these are likely to be one-off in nature, and in both cases the magnitudes are uncertain.

A third factor will be the implementation of the GST. It appears that the GST will probably be implemented later in the fiscal year. The transition to the GST is so complicated from an administrative and technology perspective that revenue collection will take some time to reach full potential.

Combined with the government's commitment to compensating the states for any shortfall in their own GST collections (relative to a baseline of 14 percent increase), the outlook must be cautious with respect to revenue collections. The fiscal gains from implementing the GST and demonetisation, while almost certain to occur, will probably take time to be fully realized.

Macro-Economic Outlook

An economy recovering from demonetisation will need policy support. On the assumption that the equilibrium cash-GDP ratio will be lower than before November 8, the banking system will benefit from a higher level of deposits. Thus, market interest rates-deposits, lending, and yields on g-secs-should be lower in 2017-18 than 2016-17.

This will provide a boost to the economy (provided, of course, liquidity is no longer a binding constraint). A corollary is that policy rates can be lower not necessarily to lead and nudge market rates but to validate them. Of course, any sharp uptick in oil prices and those of agricultural products, would limit the scope for monetary easing.

Fiscal policy is another potential source of policy support. This year the arguments may be slightly different from those of last year in two respects. Unlike last year, there is more cyclical weakness on account of demonetisation.

Moreover, the government has acquired more credibility, because of posting steady and consistent improvements in the fiscal situation for three consecutive years, the central government fiscal deficit declining from 4.5 percent of GDP in 2013- 14 to 4.1 percent, 3.9 percent, and 3.5 percent in the following three years. But fiscal policy needs to balance the cyclical imperatives with medium term issues relating to prudence and credibility.

Exchange Rate Policy

Given India's need for exports to sustain a healthy growth rate, it is important to track India's competitiveness.

A second reason to review India's competitiveness is the rise of countries such as Vietnam, Bangladesh, and the Philippines that compete with India across a range of manufacturing and services.

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A simple look at the indices of real effective exchange rates suggests that since the crisis of 2013, India's rupee has appreciated by 19.4 percent (October 2016 over Jan 2014) according to the IMF's measure, and 12.0 percent according to the RBI's measure.

Both these indices could be potentially misleading. The RBI's measure for example assigns an unusually high weight to the United Arab Emirates as it is a major source of India's oil imports, and a trans-shipment point for India's exports. But little of this trade has to do with competitiveness.

The surprising finding is that the IMF and RBI indices overstate the rupee's appreciation since 2014, largely because they give such a large weight to the euro, which has been exceptionally weak. When the rupee is compared mainly to the comparatively stronger Asian currencies both REERASIA-M and REER-ASIA-H show the loss of competitiveness has been much less, 8.3 percent and 10.4 percent respectively (October 2016 over January 2014).

In other words, India has managed to maintain export competitiveness despite capital in?ows and in?ation that has been greater than in trading partners. Re?ecting this, India's global market share in manufacturing exports has risen between 2010 and 2015.

Trade Policy

At a time of a possible resurgence of protectionist pressures and India's need for open markets abroad to underpin rapid economic growth domestically, it is increasingly clear that India and other emerging market economies must play a more proactive role in ensuring open global markets.

At the same time, with the likely US retreat from regional initiatives such as the Trans-Pacific Partnership (TPP) in Asia and the Trans-Atlantic Trade and Investment Partnership (TTIP) with the EU, it is possible that the relevance of the World Trade Organization might increase. As a major stakeholder and given the geo-political shifts under way, reviving the WTO and multilateralism more broadly could be proactively pursued by India.

Women

This burden on women can take several forms: threat to life and safety while going out for open defecation, reduction in food and water intake practices to minimize the need to exit the home to use toilets, polluted water leading to women and children dying from childbirth-related infections, and a host of other impacts.

Women's personal hygiene is therefore important not just for better health outcomes but also for the intrinsic value in conferring freedom that comes from having control over their bodies, a kind of basic right to physical privacy. Put differently, impeded access may well be creating "gender-based sanitation insecurity."

Other Random Observations

1. New estimates based on railway passenger traffic data reveal annual work-related migration of about 9 million people, almost double what the 2011 Census suggests.

2. China's credit rating was upgraded from A+ to AA- in December 2010 while India's has remained unchanged at BBB-. From 2009 to 2015, China's credit-to-GDP soared from about 142 percent to 205 percent and its growth decelerated. The contrast with India's indicators is striking, which have remained low in range of 70-80.

3. Welfare spending in India suffers from misallocation: as the pair of charts show, the districts with the most poor (in red on the left) are the ones that suffer from the greatest shortfall of funds (in

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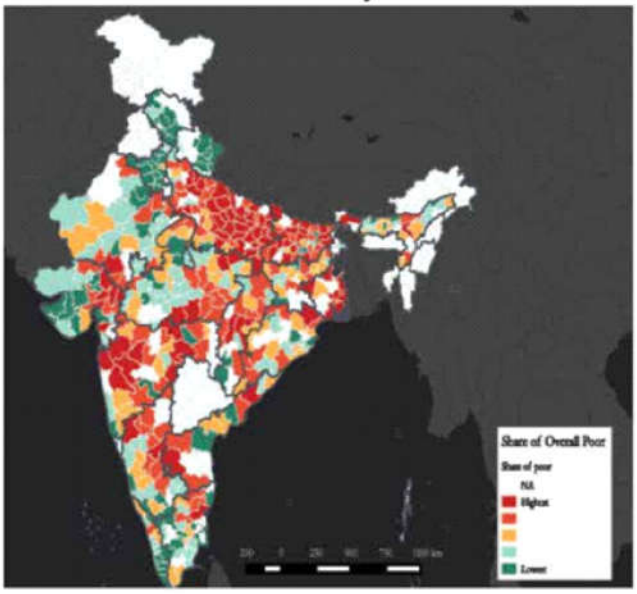
red on the right) in social programs. The districts accounting for the poorest 40% receive 29% of the total funding.

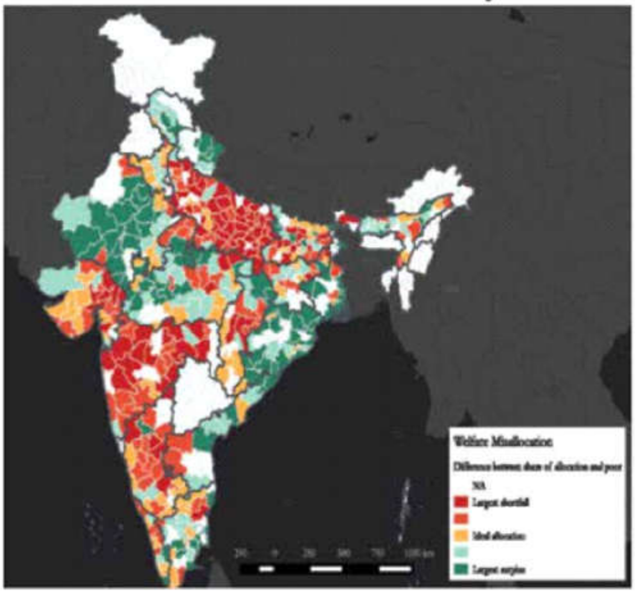
4. India has 7 taxpayers for every 100 voters ranking us 13th amongst 18 of our democratic G-20 peers.

5. India's share of working age to non-working age population will peak later and at a lower level than that for other countries but last longer. The peak of the growth boost due to the demographic dividend is fast approaching, with peninsular states peaking soon and the hinterland states peaking much later.

Share of Poor by District



Shortfall in Allocation to Poor by District



Supplementary Readings

A. JAM Trinity

JAM stands for three things - the Jan Dhan Yojana, the Aadhaar initiative of UIDAI and Mobile number. These three things are now often called the Trinity of reforms in India. The JAM Trinity holds the key to one of the biggest pieces of reform ever attempted in India, i.e., direct subsidy transfers. The NDA government is pinning its hopes on these three modes of identification ((JAM) to deliver direct benefits to India's poor.

Until now, the government has operated a multitude of subsidy schemes to ensure a minimum standard of living for the poor. These take the traditional delivery routes to deliver affordable products or services to them. So, we have the MGNREGA, operated through the panchayats, which pays minimum wages to rural workers. The Centre and States supply rice, wheat, pulses, cooking oil, sugar and kerosene at heavily subsidised prices through the PDS. Then, sectors such as power, fertilisers and oil sell their products to people below market prices. It is natural that such subsidies cost the exchequer quite a bit. Yet, as they make their winding way through the hands of intermediaries, leakages, corruption and inefficiencies eat away large parts.

It is here that the government is quite confident that the three constituents of JAM could be of immense help. With Aadhaar helping in direct biometric identification of disadvantaged citizens and Jan Dhan

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bank accounts and mobile phones allowing direct transfers of funds into their accounts, it may be possible to cut out all the intermediaries. Thus JAM Trinity has become such an important part of Indian economy that within launch of this terminology it has become immensely popular in financial circles.

To implement the concept of JAM trinity we have to overcome various challenges like lack of infrastructure facilities in terms of access to banking facilities especially in remotest areas, privacy and security issues in ADHAAR.

B. Credit Rating Agencies

Credit rating agencies are whistleblowers. They have expertise in the art of monitoring, evaluation and forecast. They offer information to the investors for taking investment decisions. They help governments to devise policies to avoid imminent crises such as recession, current account deficit, fiscal deficit, other macroeconomic imbalances such as inflation or deflation. They, nevertheless, have to be transparent and accountable. They have to behave with responsibility and caution otherwise they can lead to panic, fear fluctuations in growth, investment and trade. In recent past it has been seen how credit rating agencies were inadequate in telling when sub-prime crisis was building in America, or sovereign debt crisis was building up in Europe.

Reasons for failure

- It was because they failed to maintain their neutrality.
- They also remained motivated by profit motive.
- Conflict of interest
- They joined hands with corporate sector and political bosses to hideously serve their purposes rather than serving the interest of investors in particular and public at large.
- They have lost their trust and respectability and now people are questioning them.

Relevant Questions

1. While demonetization was targeted at black money and corruption, its immediate benefits would be realized in terms of better tax compliance and tax/GDP ratio. Examine.
2. The REER calculation doesn't adequately explains the performance of Indian merchandise trade and services export. Examine the reasons and discuss the performance of Indian rupee?
3. Discuss the underlying factors responsible for successful implementation of fiscal consolidation despite the challenges like 7th Pay commission, rising oil prices, etc? Also analyze the potential impact of GST on maintenance of FRBM targets from 2019 onwards.
4. Comment on accuracy and credibility of international credit ratings while analysing their past performance? Is there is any discrepancy in their present assessment?

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2 THE ECONOMIC VISION FOR PRECOCIOUS, CLEAVAGED INDIA

Context

With a paradigm shift in Economic model in 1990s, by which India transitioned from protectionist inward oriented closed economy towards more free liberalized economy (by facilitating freer trade, easy foreign capital flow, rationalizing working of PSU and reinventing role of government as a facilitator). A vast and diverse country, which started poor, was courageous enough to adopt a democratic government and economic structure and in the course has achieved spectacular socio-economic development. However the still persisting ambivalence towards private sector, inefficient state machinery which fails in effective redistribution, must embrace the path of reform with a broader social shift in ideas and vision.

Technical Terms

A. **Trade to GDP ratio:** Export plus import expressed as share of GDP. It is a marker of economic liberty of an economy. The trade to GDP ratio of India significantly improved post 1990's reform.

B. **Retrospective tax:** A tax levied for transactions in the past (which was either taxed at lower rate or was tax free owing to exemptions).e.g. Vodafone tax issue. A retrospective tax is considered to be regressive and anti market as it erodes government's credibility and adds to policy uncertainty.

C. **Twin Balance sheet problem:** It refers to the poor economic state of Public sector banks at one hand (huge Non Performing Assets) and Corporate houses on other (due to low profitability and shortage of loan).In case of India both these problems are interdependent as a majority share of NPA with the banks are from the corporates and DISCOMS. This has created a vicious cycle whereby banks avoid lending corporates and corporates fail to repay their debt owing to lack of capital and profitability.

D. **Competitive federalism:** It refers to a tendency among states to compete and outperform each other in attracting more economic investment in their state e.g. newly formed state of Telangana and Andhra Pradesh rank in the top of the "Ease of doing business" list.

E. **Exclusion Error:** Deserving candidates do not receive benefits.

F. **Inclusion error:** Non deserving receive benefits.

G. **Leakage:** Benefits siphoned off by corruption and inefficiency.

H. **Exit issue:** The obstacles faced by firms, wanting to wrap up their business. Exit issue in India is one of the prominent reasons for its poor ranking in ease of doing business.

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Gist of Economic Survey Chapter

Introduction

Economic vision animating Indian policy can be divided into two phases, first socialism and then 'Washington consensus' phase starting after 1991 reforms.

During socialism phase,

- The guiding principles were economic nationalism and protectionism.
- Public sector occupied the commanding heights and
- Government intruded into even the most micro-decisions of private firms: their investing, producing, and trading.

This framework was rejected after 199 but what replaced it is still not clear. At one level one thinks that India has replaced its erstwhile socialist vision with something resembling the "Washington Consensus": open trade, open capital, and reliance on the private sector. Reforms along these lines have carried by all governments. In past few years reforms like:

- Institutionalized a commitment to low inflation in the new monetary policy framework agreement
- Focus on improving Ease of Doing Business
- Passage of GST Bill, Bankruptcy code

Economic Transformation in past 25 years

As a result of these steps remarkable economic transformation has been achieved in last 25 years. This transformation can be measured using four standard measures: openness to trade; openness to foreign capital; the extent to which public sector enterprises dominate commercial activities; and the share of government expenditure in overall spending.

A. Openness to trade (measured in Trade to GDP ratio):

- India's ratio has been rising sharply, particularly over the decade to 2012, when it doubled to 53 per cent (India has Trade to GDP ratio of nearly 15% in 1991, 26% in 2002). As a result, India's ratio now surpasses China.
- India also trades more and has better trade to GDP ratio as compared to similar geographically sized countries like US, Brazil and Russia. (Small countries trade more with outside world, whereas big countries trade less with outside world because of large internal market).

B. Openness to foreign capital

- Despite significant capital controls, India's net inflows are, in fact, quite normal compared with other emerging economies. India's FDI has risen sharply over time. In fact, in the most recent year, FDI is running at an annual rate of $75 billion, which is not far short of the amounts that China was receiving at the height of its growth boom in the mid-2000s.

C. Size of PSUs:

- Going against the popular perception, the share of PSUs in market has been coming down in wake of liberalization and entry of private players in sectors like telecom, civil aviation, financial services etc.

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- These have all served to reduce the share of the public sector even if there has not been much exit of the PSU enterprises themselves. In India PSUs sale constitute 17% of national sale whereas they constitute around 27% in China.

D. Share of government expenditure in overall spending

- If we consider government expenditure against per capita of GDP, India spends as much as can be expected given its level of development.

In sum, the standard measures suggest that India is now a "normal" emerging market, pursuing the standard Asian development path and has progressed well and has grown at about 4.5 percent per capita for thirty seven years. This achievement has been remarkable because India has achieved this under a fully democratic system. The only other countries that have grown as rapidly and been democratic for a comparable proportion of the boom are Italy, Japan, Israel, and Ireland. Other countries that have grown faster for as long have tended to be oil exporters, East Asian countries,

The Road To Be Traversed

Despite of these achievements there is a sense that India has not reached a desirable and optimal point, which can be explained as:

- There has been a hesitancy to embrace the private sector
- State capacity has remained weak ,
- And, redistribution has been simultaneously extensive and inefficient

A. Ambivalence about private sector and property rights

All states, all societies, have some ambivalence toward the private sector because of conflicting objectives of social concerns of state and profit maximization of private players. But the ambivalence in India seems greater than elsewhere as was found in World Value Survey. The symptoms of this ambivalence toward the private sector manifest in multiple ways, like:

- Difficulty to privatize public enterprises even for sectors which belong to private players, for example Air India in civil aviation, banking, fertilizer sector.
- In agriculture sector the compulsory requirement to sell in authorized markets through certain middleman under APMC (Agricultural Produce Market Committee) Act also reflects it.
- Moreover, policy reform in the sector has been interventionist reflected in restrictions on pricing.
- Ambivalence of past towards property rights, is visible in 'retrospective taxation' of present. This is true in a number of recent cases, including Vodafone and Monsanto.
- There is hesitation in taking decision for being seen as favoring the private sector, for example in debt write-offs by banks.

B. State capacity:

Indian economic model is characterized by the weakness of state capacity, especially in delivering essential services such as health and education. Indian state capacity has not increased as those of other emerging countries. The Indian state has low capacity, with high levels of corruption, clientism, rules and red tape.

Though Indian competitive federalism has focused on attracting investment and competitive populism, it has not focused much on issue of essential service delivery especially in health and education sector,

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except for few exception like PDS reform in Chhattisgarh, Kerosene free derive in Haryana and power sector reforms in Gujarat. This weak state capacity has created various problems like:

- It inhibits effective service delivery
- Constrains policy making in certain areas, as state do not want to be seen as favoring particular interests. It has further created problems like:
  - Strict adherence to rules that may not necessarily be optimal public policy. For example auctioning cannot always be the optimal policy for selling all natural resources.
  - Abundant precaution in bureaucratic decision making because of fear of four Cs, CBI, CVC, CAG and courts.

C. Inefficient distribution:

Indian state welfare spending suffers from considerable misallocation. This leads to: exclusion errors (the deserving poor not receiving benefits), inclusion errors (the non-poor receiving a large share of benefits) and leakages (with benefits being siphoned off due to corruption and inefficiency). Some plausible explanations for it are:

- India has followed a unique pathway to economic success, what might be called **"Precocious, Cleavaged India"** which explains these anomalies.
- Indian economic progress was achieved simultaneous to political progress. Whereas in other countries like developed economies, economic development preceded political development. Universal franchise and other political rights put extra demands on low economically developed Indian state, whereas such demands were not present for authoritarian states or states which benefited from industrialization of 19th century.
- Along with this India was a highly cleavage society, with more cleavages than any other society: language and scripts, religion, region, caste, gender, and class.

This along with shining example of USSR created a intellectual zeal for 'socialism' and natural distrust for private sector (especially because of failure of private sector under colonial rule in India and in other countries).Under these circumstances India adopted mixed economic model, which resulted into

- Strict controls over private sector.
- India adopting for redistribution early in the development process, when its state capacity was particularly weak.
- Low investment in human capital - for instance, public spending on health was an unusually low 0.22 per cent of the GDP in 1950-51 - because of low resources.
- Inefficient redistribution, using blunt and leaky instruments.

Though interventions began under compulsion, there is only partial explanation for failure to exit. Exit is difficult everywhere but it can be especially difficult in a poor, cleavaged democracy dominated by vested interests, weak institutions and an ideology that favors redistribution over investments

Normally states provide essential services (physical security, health, education, infrastructure, etc.) first before they take on their redistribution role, because unless the middle class in society perceives that it derives some benefits from the state, it will be unwilling to finance redistribution. Otherwise the middle class will seek to exit from the state, which is reflected in lower number of taxpayers relative to voting

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age in India. This exit will further shrink the state, erodes its legitimacy, further reduces resources and state will enter into a vicious cycle.

Conclusion

India has come a long way in terms of economic performance and reforms. But there is still a journey ahead to achieve both dynamism and social justice. One tentative conclusion is that completing this journey will require a further evolution in the underlying economic vision across the political spectrum which should focus on improving state capacity, trusting private sector and improving redistribution delivery.

Related questions

1) Which factors inhibit India from achieving its true potential in terms of economic growth? Assess the requirement of third generation reforms in this regard.

2) Is democracy antithesis to economic development, especially for a poor state with high level of cleavaged society? Critically examine.

3) The Washington Consensus was based on certain principles, which have been found incapable to deal with crisis situations, as they cripple state capacity. Critically analyze in context of Asian currency crisis of 1997 and Global recession since 2008.

4) Critically discuss India's approach towards liberalization of economy. Suggest appropriate policy measures to address the issues faced by India in this regard.

5) It is often argued that "a government should take on to redistribution only after earning legitimacy". Do you agree? Substantiate your argument with an example.

6) Discuss, what shall be the key principles for future growth and reforms strategy in wake of 2008 crisis?

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3 DEMONETISATION: TO DEIFY OR DEMONIZE?

Context

The unprecedented policy decision by the Government to Demonetize the economy of the higher denomination currencies (i.e. Rs. 500 and Rs. 1000), comprises of three broad aspects i.e.

- **A money supply contraction (of only Cash)**
- **A tax on unaccounted private wealth(i.e. Black money)**
- **A tax on saving outside formal financial system.**

With the objective of cracking down on Black money, counterfeit (fake currency), terror activity (fed by the first two) and progressive transition towards a cashless inclusive digital economy, the bold step of Demonetization has received a mixed bag of outcomes, though the full range of impacts can only be understood over one financial year (at least).Hence, the Government's approach is (and should be) to take further policy actions to minimize short term costs and maximize long term benefits.

Technical Terms

A. **SIT (Special Investigation Team):** A team of professional investigators appointed by the Supreme court to look into the issue of black money (source, destination, ways to bring back money stashed abroad and ways to stop generation of same)

B. **Money:** It is the commonly accepted medium of exchange .It also acts as convenient unit of account (of all goods and services) and a store of value for individuals (i.e wealth can be stored in terms of money for future use).

C. **Fiat Money:** Currency notes and coins are called fiat money, which do not have intrinsic value (like gold or silver).These are also called legal tenders as they can not be refused by any citizen of the country for settlement of any kind of transaction.

D. **Money Supply/Liquidity:** The notes, coins, Demand Deposits(saving/current) are considered as money.

E. **Black Money:** Funds earned on the black market on which income and other taxes have not been paid or which is the proceeds of criminal activity such as bribery and corruption.

F. **Soil rate:** Rate at which notes are considered to be too damaged to use and are returned to the Central Bank. Generally the higher denomination notes have a lower soil rate than the low denomination notes.

G. **Global Financial Crisis:** It refers to a global scale financial crisis, which originated from the sub-prime mortgage market in USA (i.e. banks providing loans on mortgages, which has less commensurate value) and developed into a full grown banking crisis(fall of Lehman Brothers). The crisis was

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followed by global economic downturn and great recession, from which the world has still not recovered fully.

H. Indirect tax revenue: A tax which is collected from the ultimate consumer of a particular Good/ Service. The tax burden lies on the final consumer and not the intermediary who transacts (e.g. sales tax, value added tax, excise duty).It is considered as a regressive tax , as it is charged at the same rate from both poor and rich(no equity).

I. Real Credit Growth: Increase in Amount of credit disbursed by the banks. Credit typically grows faster than GDP as the economy develops (more matured).

J. Nominal GDP: It refers to the Gross domestic product evaluated at current market price, whereas the real GDP evaluates GDP at prices of Base year (i.e a standard year)

K. GDP Deflator: It is a measure of the level of prices of all new, domestically produced, final goods and services in an economy. It is calculated by dividing Nominal GDP/Real GDP

L. Quantity theory of Money:

MV = PY, where [M refers to the money supply ,V is velocity, the rate at which money turns over, P is the price level ,Y is real GDP]

- If the money supply is reduced, either the remaining stock of money will need to be used more intensively, or else nominal GDP will fall.

M. Informal Economy: The informal sector, informal economy, or grey economy is the part of an economy that is neither taxed, nor monitored by any form of government. Unlike the formal economy, activities of the informal economy are not included in the gross national product (GNP) and gross domestic product (GDP) of a country. e.g street vendors in Indi

N. Internal Convertibility: The ability of an economy to be able to convert cash into bank deposits and vice versa. The greater the convertibility , more is the confidence in formal banking system.

O. Negative interest rates policy: negative interest rate policy means financial institutions like banks will be penalised for keeping money. This will encourage them to lend it for economic activity.

P. Helicopter drop/helicopter money: The idea of a helicopter money drop has been mooted by Milton Friedman and Ben Bernanke, among others. It means giving everyone direct money transfers. In theory, people would see this as a permanent one-off expansion of the amount of money in circulation and would then start to spend more freely, increasing broader economic activity and pushing inflation back up to the central bank's target.

Gist of Economic Survey Chapter

On 8th November demonetization was announced with the aim of the action was fourfold: to curb corruption; counterfeiting; the use of high denomination notes for terrorist activities; and especially the accumulation of "black money", generated by income that has not been declared to the tax authorities.

It followed a series of earlier efforts to curb such illicit activities, including:

- The creation of the Special Investigative Team (SIT) in the 2014 budget;
- The Black Money and Imposition of Tax Act 2015;
- Benami Transactions Act 2016;

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- The information exchange agreement with Switzerland;
- Changes in the tax treaties with Mauritius, Cyprus and Singapore; and
- The Income Disclosure Scheme.

Demonetisation was aimed at signalling and emphasizing the government's determination to penalize illicit activities and the associated wealth. India's demonetization was unprecedented in international economic history because:

- It was highly secretive and sudden
- It was carried out in normal economic and political condition exemplified by macro-economic stability and fastest GDP growth rate. All other sudden demonetisations have occurred in the context of hyperinflation, wars, political upheavals, or other extreme circumstances.

In India there were two previous instances of demonetisation, in 1946 and 1978, the latter not having any significant effect on cash, but the recent action had large, albeit temporary, currency consequences.

Globally new monetary policy tools like negative interest rates policy and 'helicopter drops' of money have been employed to stimulate growth and increase money supply. India on the other hand instead of expanding money supply has squeezed it and it can be called as 'reverse helicopter drop' or 'helicopter hoover'.

Demonetization's Economic Impact in the Short and Medium Run

Calculating impact of demonetization will be a tedious task and require that certain important facts must be kept in mind.Certain facts which are relevant for understanding the rational of demonetization are:

- **Currency to GDP** ratio was increasing in India and was around 12% in 2014-15. The ratio of high demonization notes was even higher.
- India's economy is relatively **cash-dependent**, even taking account of the fact that it is a relatively poor country (cash component of economy decreases with development).
- It may suggest that some of the cash holding was not used for legitimate transactions, but perhaps for other activities such as corruption.
- 'Soil rates' of high denomination notes (11% for 1000, 22% for 500 and 33% for smaller denomination notes) are lower as compared to lower denomination notes and similar high denomination notes in US. It indicate that all high denomination notes are not used for transactions but for storing money, especially black money of about Rs. 3 lakh cr or 2% of GDP.

Based on this assumption demonization would have long term benefit of reducing corruption.

In this assumption few things which must be kept in mind are:

- According to Transparency International data cash in circulation in India is relatively high for its level of corruption. This means that either level of corruption is much worse or cash is being used for legitimate purpose.
- **Level of high denomination notes:** In India's case, the **denomination/ income ratio** has fallen sharply over the past quarter century because incomes have been growing rapidly and India stands midway in low income group countries on this count. This also shows that higher denomination notes have been increasingly used for transactions over time.

How to Look at Demonetization

Demonetisation should be seen as comprising the following:

- A money supply contraction but only of one type of "money"—cash;
- A tax on unaccounted private wealth maintained in the form of cash – black money; and
- A tax on savings outside the formal financial system.

Benefits of Demonetization

A. Tax on black money

Demonetization offered three options for black money holders:

- Declare their income, deposit it and pay tax rate with penalty
- Continue to hide and suffer 100% tax rate
- Launder their money

Anecdotal evidence says that there was money laundering through various methods like:

- Retime the accrual of money and then depositing in account
- Paying intermediaries to convert black money into white (as commission, payment for standing in queue, depositing in others account)

Despite these demonetization provided following benefits

- In all these cases, black money holders still suffered a substantial loss, in taxes or "conversion fees".
- Laundering run the risk of punitive taxes and prosecution, in addition to the fees or taxes already paid because of continuous surveillance and data mining by government on spooky deposits.
- The December 30, 2016 Ordinance has declared the unreturned notes as no longerconstituting legal tender and this will extinguish RBI liability and increase its net worth.

In this sense, demonetisation has affected a transfer of wealth from holders of illicit black money to the public sector, which can then be redeployed in various productive ways – to retire government debt, recapitalize banks, or even redistribute back to the private sector.

B. Tax compliance

- Demonetization has shown state's resolve to crack down on black money
- **Social condemnation**: Since this action has commanded support amongst the population, demonetisation shows that black money will no longer be tolerated by the wider public.

These two effects if combined with other incentive measures can result into behavioural change among people and greater tax compliance.

- Demonetisation could also aid tax administration in another way, by shifting transactions out of the cash economy and into the formal payments system.
- As a result, the tax-GDP ratio, as well as the size of the formal economy, could be permanently higher.

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- **It will channel more** savings into financial system. It will help banks in providing more loans at lower rates.
- In the longer-term, if demonetisation is successful, it will reduce the equilibrium cash-GDP and cash-deposits ratio in the economy. This will increase financial savings which could have a positive impact on long run growth.

Early Evidence of Potential Long Term Benefits

Though it will take several years to see the impact of demonetization on illicit transactions, on black money, and on financial savings, there are some signs pointing to change.

A. Impact on Digitization

One intermediate objective of demonetisation is to create a less-cash or cash-lite economy, as this is a key to channelling more saving through the formal financial system and improving tax compliance.

Watal Committee has recently estimated that cash accounts for about 78 percent of all consumer payments.And there are many reasons for this situation. Cash has many advantages:

- It is convenient, accepted everywhere, and
- Its use is costless for ordinary people, though not of course for society at large.
- Cash transactions are also anonymous, helping to preserve privacy, which is a virtue as long as the transactions are not illicit or designed to evade taxation.

In contrast, digital transactions face significant impediments.

- They require special equipment, cell phones for customers and Point-Of-Sale (POS) machines for merchants, which will only work if there is internet connectivity.
- They are also costly to users, since e-payment firms need to recoup their costs by imposing charges on customers, merchants, or both.

At the same time, these disadvantages are counterbalanced by two cardinal virtues.

- Digital transactions help bring people into the modern "wired" era.
- And they bring people into the formal economy, thereby increasing financial saving, reducing tax evasion, and levelling the playing field between tax-compliant and tax-evading firms (and individuals).

In the wake of the demonetisation, the government has taken a number of steps to facilitate and incentivize the move to a digital economy. These include:

- Launch of the **BHIM (Bharat Interface for Money) app** for smart-phones based on the new Unified Payments Interface (UPI) which has created inter-operability of digital transactions.
- Launch of **BHIM USSD 2.0, a** product that allows the 350 million feature phone users to take advantage of the UPI.
- Launch of **Aadhar Merchant Pay**, aimed at the 350 million who do not have phones. This enables anyone with just an Aadhar number and a bank account to make a merchant payment using his biometric identification.
- Reductions in fees (Merchant Discount Rate) paid on digital transactions and transactions that use the UPI.

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- There have also been relaxations of limits on the use of payment wallets.
- Tax benefits have also been provided for to incentivizedigital transactions.
- Encouraging the adoption of POS devices beyond the current 1.5 million, through tariff reductions.

As a result of all these number of digital transactions has increased considerably. Data from the National Payments Corporation of India (NPCI) show that RuPay-based electronic transactions increased by about Rs. 13,000 crore in case of POS transactions and about Rs. 2,000 crore in e-commerce, an increase of over 300-400 percent.Same has been the case with debit card, credit card and AEPS (Aadhar-Enabled Payments System) transactions.

The success of digitalization will depend considerably on

- The inter-operability of the payments system. The Unified Payments Interface (UPI) created by the NPCI is the technology platform that will be the basis for ensuring interoperability. But to ensure this, individual banks should facilitate not thwart inter-operability.
- As digital payments increase the security features of these e-payment systems will need to inspire trust, to ensure this trend continues.

B. Impact on Real estate sector

- Demonetization can have profound impact on real estate prices as black money was used evade taxes on property sale and have resulted into inflated prices. According to Knight Frank and Survey calculations real estate prices in eight major cities has started declining post demonetization.
- Reduction in real estate prices is desirable as it will lead to affordable housing for the middle class, and facilitate labour mobility across India currently impeded by high and unaffordable rents.

Short Term Impacts

A. Impact on cash/money

- The true extent of the cash reduction was much smaller than commonly perceived, and the true peak of the monetary – as opposed to the psychological – shock occurred in December (35% shortfall), rather than November (25% shortfall).
- The shortfall is now narrowing rapidly. At end-December 2016, effective currency was only about 65 percent of estimated demand, but this is likely to rise to about 86 percent of transactions demand by end-February.

B. Impact on GDP

Demonetisation is potentially:

- An **aggregate demand shock**, because it reduces the supply of money and affects private wealth (especially of those holding unaccounted money and owning real estate);
- An **aggregate supply shock** to the extent that cash is a necessary input for economic activity (for example, if agricultural producers require cash to pay labour);
- An **uncertainty shock** because economic agents face imponderables related to the impact and duration of the liquidity shock as well as further policy responses.

To analyze the impact of demonetization on GDP in a macro-assessment on five broad indicators are focused:

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- Agricultural (rabi) sowing;
- Indirect tax revenue, as a broad gauge of production and sales;
- Sales generally, as a measure of discretionary consumer spending, and two-wheelers in particular as it is the best available indicator of rural and demand of the less affluent;
- Real estate prices; and
- Real credit growth

The high frequency indicators present a mixed picture.

- Agricultural sowing, passenger car sales, and overall excise taxes bear little imprint of demonetisation;
- And sales of twowheelers show a marked decline after demonetisation;
- Credit numbers were already looking weak before demonetisation, and those pre-existing trends were further reinforced after November 8.

Dual Dimension of Cash

	Origin/nature	
	White	*Black*
Function		
Transactions	Company pays employee salary in cash; payment and receipt are declared to tax authorities	Small enterprise pays for input in cash; neither declares the transaction to tax authorities
Store of value	Household keeps savings in cash for emergencies	Businessman hoards undeclared cash, with a view to distributing it to his candidate during elections

Effect on Economic Activity (Informal economy and formal economy)

- Informal economy has been effected by cash crunch
- Formal economy would have minimal direct impact but indirect impact, as workers who had been laid-off will buy fewer products like FMCG products, two wheelers.
- Conversely, some participants in the informal economy have shifted into the formal payments systems (such as kirana shops installing POS terminals).
- Also, in the cash intensive economy, the liquidity shortage has led at least transiently to a greater recourse to informal credit (such as kirana shops allowing regular customers to pay at a later date).
- It is also to be noted that recorded part of the economy will underestimate the impact of demonetization because of most of informal economy is unrecorded or data from formal sector is used to estimate for it.

Supply Side Effects

What are the possible supply side shocks?

- It is likely, for example, that uncertainty caused consumers to postpone purchases and firms to put off investments in the third quarter.

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- Similarly, there was clearly a wealth shock in the initial months, as cash assets were turned into the banks (from where they were difficult to withdraw),
- Demonetisation could also affect supplies of certain agricultural products, especially milk (where procurement has been low), sugar (where cane availability and drought in the Southern states will restrict production), and potatoes and onions (where sowings have been low).

But as the economy is remonetised, restrictions are lifted and conditions normalise, the uncertainty and cash crunch should dissipate and spending might well rebound toward the end of the fiscal year.

However vigilance is needed against agriculture products price shooting up.

Based on all these factors it would be reasonable to conclude that economic activity has been affected adversely, but temporarily, by demonetisation in between ¼ and ½ percentage points relative to the baseline of about 7 percent and will be around $6^3/4$ and $7^1/2$. Over the medium run, the implementation of GST, follow-up to demonetization and other structural reform measures should take the trend rate of growth of the economy to the 8-10 percent range that India needs.

All these relatively benign outcome would materialise, however, if and only if remonetisation is effected expeditiously (it has been estimated that around 90 percent of transactions demand can be met before the end of current financial year), and decisive policy actions taken to clear away the uncertainty and dispel fears of an overzealous tax administration. Only then could the effects of demonetisation prove non-permanent in nature.

Redistribution to the Government

Demonetisation will also redistribute resources.

The most important redistributive effect is that it will shift resources from the private sector to the government. The impact on the overall economy will then depend on how the government responds.

Demonetisation will affect the fiscal accounts in the following ways.

- Wealth gain: The RBI/government may receive some gains from the unreturned cash
- Income taxes could go up as black money was deposited in bank accounts
- There are also reports of increases in tax payments at state government levels and accelerated payments to discoms.

Against this are three negative effects:

- Costs of printing new notes over and above normal replacement.
- The costs of sterilizing the surge in liquidity into the banking system via issuance of Market Stabilization Scheme bonds.
- If nominal GDP growth declines, corporate and indirect tax revenues of the centre could decline but so far there is no clear evidence.

Markers of success

Though the benefits of demonetization will become visible in long term, but there are markers which will indicate future success. These are:

- Changes in the use of digital payment methods across the three categories of digital access identified earlier, namely, smart phone users, regular phone users and the phoneless, respectively.

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- The cash-GDP ratio, which should decline as more saving, is channeled through the formal financial system and black money falls.
- The most important marker of success will be taxes. The number of new income tax payers as well as the magnitude of reported and taxable income should go up over time.

To the extent that demonetisation has also raised the costs of non-compliance with indirect taxes, we should also expect to see an increase in registration under the service and excise taxes and under the states' VATs.These should drift up steadily in the future.

Maximizing long-term benefits, minimizing short-term costs

Moving forward, the emphasis must be on maximizing demonetization's benefits while minimizing its costs. Certain steps which should be taken to achieve this are:

- The most important effort must be to replenish the cash shortage as quickly as possible.
- The government windfall arising from unreturned notes should be deployed toward capital-type expenditures rather than current ones.
- Since the windfall will be one-off its use should be one-off and not lead to entitlements that create permanently higher expenditures.
- In the medium term, the impetus provided to digitalization must continue.
- The transition to digitalization must be gradual; take full account of the digitally deprived; respect rather than dictate choice; and be inclusive rather than controlled.
- To increase trust in digital payments, cyber security systems must be strengthened considerably.
- One key need is to ensure inter-operability of the payment system, which will be at the heart of increasing digitalization going forward, building upon the newly created UPI.
- Measures to complement demonetization with other non-punitive, incentive-compatible measures that reduce the incentives for tax evasion should be taken.

Demonetization was a powerful stick which now needs carrots as complements. A five-pronged strategy could be adopted:

- A GST with broad coverage to include activities that are sources of black money creation—land and other immovable property—should be implemented;
- Individual income tax rates and real estate stamp duties could be reduced;
- The income tax net could be widened gradually and, consistent with constitutional arrangements, could progressively encompass all high incomes;
- The timetable for reducing the corporate tax rate could be accelerated; and
- Tax administration could be improved to reduce discretion and improve accountability.
- There must be a shift to greater use of data, smarter evidence-based scrutiny and audit, greater reliance on on-line assessments with correspondingly less interaction between tax payers and tax officials, greater coordination between different tax authorities
- Big Data and the digital age, and the promise they offer, should also be embraced by the tax administration.

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Conclusion

As it is unwise to predict the range of impact of Demonitaization beforehand(many macro economic data are not available and there is a gestation period for economic policies to show impact, which are dependent on many other complex variables), the endeavor should be to minimize the short term costs and increase long term benefits by -faster and prompt demonetization- facilitating internal convertibility -creating capital assets out of the extra revenue-facilitating and incentivizing digitization-reforming tax administration to incentivize and encourage genuine tax payers, while at the same time strengthening cyber security to generate trust among people.

Impact of Demonetisation

Sector	Impact	
	Effect through end-December	**Likely longer-term effect**
Money/ interest rates	Cash declined sharply	Cash will recover but settle at a lower level
	Bank deposits increased sharply	Deposits will decline, but probably settle at a slightly higher level
	RBI's balance sheet largely unchanged: return of currency reduced the central bank's cash liabilities but increased its deposit liabilities to commercial banks	RBI's balance sheet will shrink, after the deadline for redeeming outstanding notes
	Interest rates on deposits, loans, and government securities declined; implicit rate on cash increased	Loan rates could fall further, if much of the deposit increase proves durable
Financial System Savings	Increased	Increase, to the extent that the cash-deposit ratio falls permanently
Corruption (underlying illicit activities)		Could decline, if incentives for compliance improve
Unaccounted income/ black money (underlying activity may or may not be illicit)	*Stock* of black money fell, as some holders came into the tax net	Formalization should reduce the *flow* of unaccounted income
Private Wealth	Private sector wealth declined, since some high denomination notes were not returned and real estate prices fell	Wealth could fall further, if real estate prices continue to decline
Public Sector Wealth	No effect.	Government/RBI's wealth will increase when unreturned cash is extinguished, reducing liabilities
Formalization/ digitilisation	Digital transactions amongst new users (RuPay/ AEPS) increased sharply; existing users' transactions increased in line with historical trend	Some return to cash as supply normalises, but the now-launched digital revolution will continue

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Real estate	Prices declined, as wealth fell while cash shortages impeded transactions	Prices could fall further as investing undeclared income in real estate becomes more difficult; but tax component could rise, especially if GST imposed on real estate
Broader economy	Job losses, decline in farm incomes, social disruption, especially in cash-intensive sectors	Should gradually stabilize as the economy is remonetized
GDP	Growth slowed, as demonetisation reduced demand (cash, private wealth), supply (reduced liquidity and working capital, and disrupted supply chains), and increased uncertainty	Could be beneficial in the long run if formalization increases and corruption falls
	Cash-intensive sectors (agriculture, real estate, jewellery) were affected more Recorded GDP will understate impact on informal sector because informal manufacturing is estimated using formal sector indicators (Index of Industrial Production). But over time as the economy becomes more formalized the underestimation will decline. Recorded GDP will also be overstated because banking sector value added is based (*inter alia*) on deposits which have surged temporarily	Informal output could decline but recorded GDP would increase as the economy becomes more formalized
Tax collection	Income taxes rose because of increased disclosure Payments to local bodies and discoms increased because demonetised notes remained legal tender for tax payments/ clearances of arrears	Indirect and corporate taxes could decline, to the extent growth slows Over long run, taxes should increase as formalization expands and compliance improves
Uncertainty/ Credibility	Uncertainty increased, as firms and households were unsure of the economic impact and implications for future policy Investment decisions and durable goods purchases postponed	Credibility will be strengthened if demonetisation is accompanied by complementary measures. Early and full remonetisation essential. Tax arbitrariness and harassment could attenuate credibility

Supplementary Reading

A. Experience of demonetization around world

1) Ghana 1982 -

- **Measures:** Demonetisation of 50 cedi notes in 1982; no exchange facility for long; freeze on bank deposits
- **Rationale:** Excess liquidity and inflation

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- **Effect:** Loss of confidence in the banking system

2) Brazil 1990

- **Measures:** Collor Plan: monetary contraction by freezing all deposits above certain limit .Deposits upto a ceiling denominated in the old currency (cruzado novo) were converted to the new currency (cruzeiro) at parity.
- **Rationale:** To fight hyperinflation
- **Effect:** Contraction of output; price moderation only very gradual due to uncontrolled re-injection of liquidity

3) Australia (1988,2015)

- **Measures:** Introduction of next generation notes with tactile features.
- **Rationale:** Prevent counterfeit
- **Impact:** The first country to have a full series of circulating polymer bank notes

4) Singapore(1999,2004)

- **Measures:** The Portrait notes, the fourth series of currency notes, were launched in September 1999 with sophisticated security features (1999).Discontinued issuance of S$10,000note and instructed banks to stop re- circulating it since October 2014; but still remained legal tender (2004).
- **Rationale:** Mitigate higher money- laundering risks associated with large-value cash transactions.

B. Concept of Cashless Economy

- A cashless economy is one in which all the transactions are done using cards or digital means. The circulation of physical currency is minimal. India uses too much cash for transactions. Most of the cash in advanced economies is floating around in the "world underground economy".
- The potential benefits of cashless economy are as follows:
  - **Faster transactions:** With the cashless system, typically three times more people can be served using a cashless system than could have been if they were paying cash. No need for queues outside ATMs, no cashout during long holidays, no waiting for a deposited cheque to be credited, and no risk of carrying currency notes in the wallet.
  - **Managing staff entitlements:** Free Vends, corporate cash, loyalty and hospitality spend are all entitlements which can be programmed on to the card, this can be refreshed, daily, weekly or monthly.
  - **Increased Sales:** It has been demonstrated that with the introduction of a cashless system can increase sales by as much 20%.Vending and Catering purchases are often dictated by the amount we have in our pockets. With the introduction of a cashless system this is never a problem; the value on the card is available 24 hours a day, 7 days a week.
  - **Cash collection – made simple! :** Time spent collecting, counting and sorting cash costs money. The cashless system offers a choice of top-up options including Payroll deduction, Credit & Debit card and Coin & Note. Removing all the cash from your site removes the security issues relating to cash handling significantly and reduces the risk of vandalism and theft from your vending and catering points of sale.

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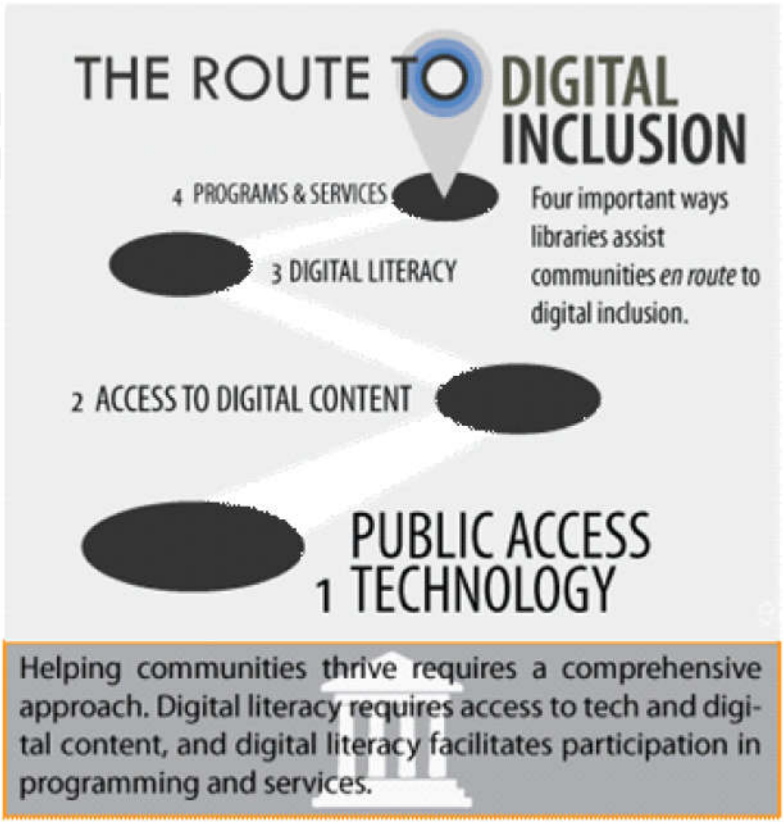
- o **Reduces Cash in Circulation:** A cashless system prevent too much of cash in the circulation thereby curb armed robbery cases and cash related crime.
- o **Job Creation:** The licensing and establishment of payment agencies will create jobs and new business opportunities.
- o **Curb on black money:** Cash transactions and black money are directly linked, since a cash trail is nearly impossible to track. As such, electronic transactions and the ease of audit they afford should make the government's job much easier in terms of curbing illegal transactions.

- **However, the biggest threat to cashless economy is Plastic card fraud. Plastic card fraud involves the compromise of any personal information from credit, debit or store cards.** The personal information stolen from a card, or the theft of a card itself, can be used to commit fraud. Fraudsters might use the information to purchase goods in your name or obtain unauthorised funds from an account. Plastic card fraud can also include 'card not present' fraud, such as the use of a card online, over the phone or by mail order, and counterfeit card fraud.

C. Concept of Digital Inclusion

- Digital inclusion is the ability of individuals and groups to access and use information and communication technologies.
- Digital inclusion is a much broader category that addresses the other two
  - o **Digital Divide**
  - o **Digital Literacy**
- **Digital inclusion has three broad facets: access, adoption, and application.** These facets show the ultimate goal of creating digitally inclusive communities.
  - o *Access:* Availability, affordability, design for inclusion, and public access.
  - o *Adoption:* Relevance, digital literacy, and consumer safety.
  - o *Application*: Economic and workforce development, education, health care, public safety and emergency services, civic engagement, and social connections.



In order to achieve these goals, digital inclusion can be promoted in four significant ways:

1. *Digital Infrastructure* - By providing free access to public access technologies (hardware, software, high-speed Internet connectivity) in their communities.

2. ***Digital Content*** - By providing access to a range of digital content to their communities.
3. ***Digital Literacy*** - By providing digital literacy services that assist individuals navigate, understand, evaluate, and create digital content using a range of information and communications technologies.
4. ***Social Programs and Services*** - By providing programs and services around key community need areas such as health and wellness, education, employment and workforce development, and civic engagement.

Relevant Questions

1. Critically examine the long term and short term benefits of demonetization. What steps should be taken to ensure that long term benefits are incentivized.
2. What are the impediments in adoption of digital payments system in India? While analysing the recent initiatives to increase digital transactions suggest steps which should be taken to increase them.
3. Critically examine the recent steps taken to curb black money, with special focus on demonetization. What other steps must be taken to curb the menace of black money
4. Critically discuss the steps taken by Government for faster transition to digital economy
5. What do you mean by informal economy? How can a transition to formal economy ensure financial inclusion?
6. What do you mean by liquidity? Discuss the fiscal and monetary control on liquidity.

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4 THE FESTERING TWIN BALANCE SHEET PROBLEM

Context

For some time, India has been trying to solve its Twin Balance Sheet problem- overleveraged companies and bad-loan-encumbered banks. NPAs continued to climb, reaching 9 percent of total advances by September (80% in PSB's). At the same time corporate profitability has reduced, their cash ?ows are deteriorating even as their interest obligations are mounting. The reason is corporations over-expand during a boom, but combination of financial crisis, delayed clearances and increasing interests left them with obligations that they can't repay. So, they default on their debts, leaving bank balance sheets impaired, as well.

This combination then proves devastating for growth, since the hobbled corporations are reluctant to invest, while those that remain sound can't invest much either, since fragile banks are not really in a position to lend to them. This has spill over effect in terms of higher cost of loans to performing borrowers and shrinking growth of loans to MSME sector. One possible strategy would be to create a 'Public Sector Asset Rehabilitation Agency' (PARA), charged with working out the largest and most complex cases. However, its success depends on staffing professionals of impeccable integrity and delinking its actions from political consequences.

Technical Terms

A. **Over-leveraged firms** - If a company is overleveraged, it has borrowed too much money and cannot make payments on the debt.

B. **Stressed assets** = NPAs + Restructured loans + Written off assets

- **NPA** - A loan whose interest and/or instalment of principal have remained 'overdue ' (not paid) for a period of 90 days is considered as NPA.
- **Restructured asset or loan** - They are that assets which got an extended repayment period, reduced interest rate, converting a part of the loan into equity, providing additional financing, or some combination of these measures.
- **Written off assets** - They are those loans/assets bank or lender doesn't count the money borrower owes to it. The financial statement of the bank will indicate that the written off loans are compensated through some other way. There is no meaning that the borrower is pardoned or got exempted from payment.

C. **Asset Quality Review** - Typically, Reserve Bank of India (RBI) inspectors check bank books every year as part of its annual financial inspection (AFI) process. However, a special inspection was

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conducted in 2015-16 in the August-November period. This was named as Asset Quality Review (AQR). In a routine AFI, a small sample of loans is inspected to check if asset classification was in line with the loan repayment and if banks have made provisions adequately. However, in the AQR, the sample size was much bigger and in fact, most of the large borrower accounts were inspected to check if classification was in line with prudential norms. The RBI believed that asset classification was not being done properly and that banks were resorting to ever-greening of accounts. Banks were postponing bad-loan classification and deferring the inevitable.

D. Ever-greening of Loan – Ever-greening refers to the practice of companies taking a fresh loan to pay up an old loan.

E. Principal agent problem - The problem of motivating one party (the agent) to act on behalf of another (the principal) is known as the principal-agent problem, or agency problem for short. The principle agent problem arises when one party (agent) agrees to work in favor of another party (principal) in return for some incentives. Such an agreement may incur huge costs for the agent, thereby leading to the problems of moral hazard and conflict of interest. Owing to the costs incurred, the agent might begin to pursue his own agenda and ignore the best interest of the principal, thereby causing the principal agent problem to occur.

Gist of Economic Survey Chapter

The chapter look into the **Twin Balance Sheet** (TBS) problem of India. After **Asset Quality Review** (AQR) by RBI, in early 2016 it became clear that India was suffering from a “twin balance sheet problem”, where both the banking and corporate sectors were under stress.

NPA Issue in Indian Banks

NPAs climbed to 9 percent of total advances by Sep 2016—double their year-ago level. In which more than four-fifths of the non-performing assets were in the public sector banks, where the NPA ratio had reached almost 12 percent. On the corporate side, Credit Suisse reported that around 40 percent of the corporate debt it monitored was owed by companies which had an interest coverage ratio less than 1, meaning they did not earn enough to pay the interest obligations on their loans.

Why TBS problem did not create bank runs during crisis?

Typically, countries with a twin balance sheet (TBS) problem follow a standard path. Their corporations over-expand during a boom, leaving them with obligations that they can’t repay. So, they default on their debts, leaving bank balance sheets impaired, as well. This combination then proves devastating for growth, since the hobbled corporations are reluctant to invest, while those that remain sound can’t invest much either, since fragile banks are not really in a position to lend to them. 4.8 This model, however, doesn’t seem to fit India’s case.

India’s TBS problem is unique, because it did not come to surface during Global Financial Crisis (2008) and even economy continued to grow at good pace. This was mainly because most of NPA’s were concentrated in the public sector banks, which not only hold their own capital, but are ultimately backed by the government, whose resources are more than sufficient to deal with the NPA problem. As a result, creditors have retained complete confidence in the banking system.

In this scenario to understand India’s TBS problem four set of Questions need to be answered.

- What went wrong – and when did it go wrong?

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- How has India managed to achieve rapid growth, despite its TBS problem?
- Is this model sustainable?
- What now needs to be done?

What went wrong – and when did it go wrong?

During the mid-2000s i.e. at time of boom firms abandoned their conservative debt/equity ratios and leveraged themselves up to take advantage of the perceived opportunities, setting off the biggest investment boom financed by an astonishing credit boom in the country's history, mainly from banks and large inflow of funds from overseas. But just as companies were taking on more risk, things started to go wrong.

- Costs soared far above budgeted levels, as securing land and environmental clearances proved much more difficult and time consuming than expected.
- At the same time, forecast revenues collapsed after the GFC; projects that had been built around the assumption that growth would continue at double-digit levels were suddenly confronted with growth rates half that level.
- Financing cost increased due to RBI increased interest rates to quell double digit inflation.
- For overseas financing rupee depreciated, forcing firms to repay debt at much high exchange rate.

Higher costs, lower revenues, greater financing costs — all squeezed corporate cash flow, quickly leading to debt servicing problems. By 2013, nearly one-third of corporate debt was owed by companies with an interest coverage ratio less than 1 ("IC1 companies"), many of them in the infrastructure (especially power generation) and metals sectors. By 2015, the share of IC1 companies reached nearly 40 percent.

How has India managed to achieve rapid growth, despite its TBS problem? (Twin Balance Sheet Syndrome with Indian Characteristics)

India followed the standard path to the TBS problem: a surge of borrowing, leading to over leverage and debt servicing problems. What distinguished India from other countries was the consequence of TBS. TBS did not lead to economic stagnation in India, as occurred in the U.S. and Europe after the Global Financial Crisis. To the contrary, it co-existed with strong levels of aggregate domestic demand, as reflected in high levels of growth despite very weak exports and moderate, at times high, levels of inflation. This is called as Balance sheet Syndrome with Indian Characteristics. This can be explained by following reasons:

- The unusual structure of its banking system (government backed public sector banks), which ensured there would be no financial crisis.
- As supply side constraints were loosened considerably during the boom, investment in infrastructure keep the pace of growth up even after GFC. In comparison, the US boom was based on housing construction, which proved far less useful after the crisis.
- Apart from it Indian financial system adopted the strategy of "give time to time", meaning to allow time for the corporate wounds to heal. Thus banks decided to give stressed enterprises more time by postponing loan repayments, restructuring by 2014-15 no less than 6.4 percent of their loans outstanding. They also extended fresh funding to the stressed firms to tide them over until demand recovered

As a result, total stressed assets have far exceeded the headline figure of NPAs. Restructured loans along with unrecognised debt (loans owed by IC1 companies that have not even been recognised as problem debts – the ones that have been "ever greened", where banks lend firms the money needed to pay their interest obligations) which are estimated at around 4 percent of gross loans, and perhaps 5 percent at public sector banks. In that case, total stressed assets would amount to about 16.6 per cent of banking system loans – and nearly 20 percent of loans at the state banks. Now the question raised is:

Is this Strategy sustainable?

For some years the financing strategy has worked, in the sense that it has allowed India to grow rapidly, despite a significant twin balance sheet problem. But this strategy may now be reaching its limits. After eight years of buying time, there is still no sign that the affected companies are regaining their health, or even that the bad debt problem is being contained.

To the contrary, the stress on corporates and banks is continuing to intensify, and this in turn is taking a measurable toll on investment and credit. Moreover, efforts to offset these trends by providing macroeconomic stimulus are not proving sufficient: the increase in public investment has been more than offset by the fall in private investment, while until demonetisation monetary easing had not been transmitted to bank borrowers because banks had been widening their margins instead. In these circumstances, it has become increasingly clear that the underlying debt problem will finally need to be addressed, lest it derails India's growth trajectory.

What needs to be done?

In these circumstances, it has become increasingly clear that the underlying debt problem will finally need to be addressed, lest it derails India's growth trajectory.

- Steps Taken by RBI to deal with the stressed asset problem which include the 5/25 Refinancing of Infrastructure Scheme, Initially, the schemes focused on rescheduling amortisations to give firms more time to repay But as it became apparent that the financial position of the stressed firms was deteriorating, the RBI deployed mechanisms to deal with solvency issues, as well.
- RBI has been encouraging the establishment of private Asset Reconstruction Companies (ARCs), in the hope that they would buy up the bad loans of the commercial banks. The problem is that ARCs have found it difficult to recover much from the debtors. Thus they have only been able to offer low prices to banks, prices which banks have found it difficult to accept.
- So the RBI has focussed more recently on two other, bank-based workout mechanisms. In June 2015, the Strategic Debt Restructuring (SDR) scheme was introduced, under which creditors could take over firms that were unable to pay and sell them to new owners. The following year, the Sustainable Structuring of Stressed Assets (S4A) was announced, under which creditors could provide firms with debt reductions up to 50 percent in order to restore their financial viability. The success of these limited by only few number of cases settled under these schemes.

Reasons Why Schemes has Limited Success

In part, the problem is simply that the schemes are new, and financial restructuring negotiations inevitably take some time. But the bigger problem is that the key elements needed for resolution are still not firmly in place:

- Ever greening of loans increased the unrecognised stress assets.
- Failure of Joint Lenders Forums to arrive on single decision.
- Proper incentives were missing for public sector bankers to grant write down under S4A scheme to restore viability. To the contrary, there is an inherent threat of punishment, since major write-downs can attract the attention of investigative agencies.

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- Recapitalisation by government under Indradhanush scheme was limited.
- Stressed assets are concentrated in a remarkably few borrowers, with a mere 50 companies accounting for 71 percent of the debt owed by IC1 debtors. Thus for the big firms the road is not littered with obstacles. It seems to be positively blocked.

All of this suggests that it might not be possible to solve the stressed asset problem using the current mechanism, or indeed any other decentralised approach that might materialise in the near future. Instead a centralised approach might be needed.

One possible strategy would be to create a **'Public Sector Asset Rehabilitation Agency' (PARA),** charged with working out the largest and most complex cases. Such an approach could eliminate most of the obstacles currently plaguing loan resolution. It could solve the coordination problem, since debts would be centralised in one agency; it could be set up with proper incentives by giving it an explicit mandate to maximize recoveries within a defined time period; and it would separate the loan resolution process from concerns about bank capital.

How would a PARA Actually Work?

It would purchase specified loans (for example, those belonging to large, over-indebted infrastructure and steel firms) from banks and then work them out, either by converting debt to equity and selling the stakes in auctions or by granting debt reduction, depending on professional assessments of the value-maximizing strategy.

Once the loans are off the books of the public sector banks, the government would recapitalise them, thereby restoring them to financial health and allowing them to shift their resources – financial and human – back toward the critical task of making new loans. For this the capital requirements would nonetheless be large.

- Part would need to come from government issues of securities.
- A second source of funding could be the capital markets, if the PARA were to be structured in a way that would encourage the private sector to take up an equity share.
- A third source of capital could be the RBI. The RBI would (in effect) transfer some of the government securities it is currently holding to public sector banks and PARA. As a result, the RBI's capital would decrease, while that of the banks and PARA would increase

Issues Need to Resolve for Proper Functioning of PARA

- First, there needs to be a readiness to confront the losses that have already occurred in the banking system, and accept the political consequences of dealing with the problem.
- Second, the PARA needs to follow commercial rather than political principles.
- The third issue is pricing. To transfer loan to PARA market prices could be used, but establishing the market price of distressed loans is difficult and would prove time consuming.

Conclusion

Addressing the stressed assets problem would require **4 R's: Reform, Recognition, Recapitalization, and Resolution**. This is the second time in a decade that such a large share of their portfolios has turned nonperforming - unless there are fundamental reforms, the problem will recur again and again. Following the RBI's Asset Quality Review, banks have recognised a growing number of loans as non-performing. With higher NPAs has come higher provisioning, which has eaten into banks' capital base. As a result,

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banks will need to be recapitalised – the third R — much of which will need to be funded by the government, at least for the public sector banks. The key issue is the fourth R: Resolution. For even if the public sector banks are recapitalised, they are unlikely to increase their lending until they truly know the losses they will suffer on their bad loans. Nor will the large stressed borrowers be able to increase their investment until their financial positions have been rectified. Until this happens, economic growth will remain under theat.

Why is a Public Sector Asset Rehabilition Agency (PARA) Needed?

The argument for PARA is developed at length in the third section. But it is worth outlining in advance the seven steps that lead to this conclusion.

1. **It's not just about banks, it's a lot about companies.** So far, public discussion of the bad loan problem has focused on bank capital, as if the main obstacle to resolving TBS was finding the funds needed by the public sector banks. But securing funding is actually the easiest part, as the cost is small relative to the resources the government commands. Far more problematic is finding a way to resolve the bad debts in the first place.
2. **It is an economic problem, not a morality play.** Without doubt, there are cases where debt repayment problems have been caused by diversion of funds. But the vast bulk of the problem has been caused by unexpected changes in the economic environment: timetables, exchange rates, and growth rate assumptions going wrong.
3. **The stressed debt is heavily concentrated in large companies.** Concentration creates an opportunity, because TBS could be overcome by solving a relatively small number of cases. But it presents an even bigger challenge, because large cases are inherently difficult to resolve.
4. **Many of these companies are unviable at current levels of debt requiring debt write-downs in many cases.** Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 percent will often be needed to restore viability. The only alternative would be to convert debt to equity, take over the companies, and then sell them at a loss.
5. **Banks are finding it difficult to resolve these cases, despite a proliferation of schemes to help them.**
6. Among other issues, they face severe coordination problems, since large debtors have many creditors, with different interests. If PSU banks grant large debt reductions, this could attract the attention of the investigative agencies. But taking over large companies will be politically difficult, as well.
7. **Delay is costly.** Since banks can't resolve the big cases, they have simply refinanced the debtors, effectively "kicking the problems down the road". But this is costly for the government, because it means the bad debts keep rising, increasing the ultimate recapitalization bill for the government and the associated political difficulties. Delay is also costly for the economy, because impaired banks are scaling back their credit, while stressed companies are cutting their investments.
8. **Progress may require a PARA.** Private Asset Reconstruction Companies (ARCs) haven't proved any more successful than banks in resolving bad debts. But international experience shows that a professionally run central agency with government backing – while not without its own difficulties -- can overcome the difficulties that have impeded progress.

Supplementary Readings

A. Steps taken by RBI to handle NPA

- **The 5/25 Refinancing of Infrastructure Scheme:** This scheme offered a larger window for revival of stressed assets in the infrastructure sectors and eight core industry sectors. Under this scheme lenders were allowed to extend amortisation periods to 25 years with interest rates adjusted every 5 years, so as to match the funding period with the long gestation and productive life of these projects.

- **Strategic Debt Restructuring (SDR):** The RBI came up with the SDR scheme in June 2015 to provide an opportunity to banks to convert debt of companies (whose stressed assets were restructured but which could not finally fulfil the conditions attached to such restructuring) to 51 percent equity and sell them to the highest bidders, subject to authorization by existing shareholders. An 18-month

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period was envisaged for these transactions, during which the loans could be classified as performing. But as of end-December 2016, only two sales had materialized, in part because many firms remained financially unviable, since only a small portion of their debt had been converted to equity.

- **Asset Quality Review (AQR):** Resolution of the problem of bad assets requires sound recognition of such assets. Therefore, the RBI emphasized AQR, to verify that banks were assessing loans in line with RBI loan classification rules. Any deviations from such rules were to be rectified by March 2016.

- **Sustainable Structuring of Stressed Assets (S4A):** Under this arrangement, introduced in June 2016, an independent agency hired by the banks will decide on how much of the stressed debt of a company is 'sustainable'. The rest ('unsustainable') will be converted into equity and preference shares. Unlike the SDR arrangement, this involves no change in the ownership of the company.

B. Mission Indradhanush - public sector banks' revamp plan

The seven shades of Indradhanush mission include:

- **Appointments**: The Government decided to separate the post of Chairman and Managing Director by prescribing that in the subsequent vacancies to be filled up the CEO will get the designation of MD & CEO and there would be another person who would be appointed as non-Executive Chairman of PSBs. This approach is based on global best practices and as per the guidelines in the Companies Act to ensure appropriate checks and balances. The selection process for both these positions has been transparent and meritocratic. The entire process of selection for MD & CEO was revamped. Private sector candidates were also allowed to apply for the position of MD & CEO.

- **Bank Board Bureau:** The BBB is a body of eminent professionals and officials, which will replace the Appointments Board for appointment of Whole-time Directors as well as non-Executive Chairman of PSBs. They will also constantly engage with the Board of Directors of all the PSBs to formulate appropriate strategies for their growth and development.

- **Capitalization:** As of now, the PSBs are adequately capitalized and meeting all the Basel III and RBI norms. However, the Government of India wants to adequately capitalize all the banks to keep a safe buffer over and above the minimum norms of Basel III. The capital requirement of extra capital for years up to FY 2019 is likely to be about Rs.1,80,000 crores. Out of the total requirement, the Government of India proposes to make available Rs.70,000 crores.

- **De-stressing PSBs** - The infrastructure sector and core sector have been the major recipient of PSBs' funding during the past decades. But due to several factors, projects are increasingly stalled/stressed thus leading to NPA burden on banks. Government is addressing problems causing stress in the power, steel and road sectors which would improve operations in these sectors and consequently De-stress PSB's

- **Strengthening Risk Control measures and NPA Disclosures** : Besides the recovery efforts under the DRT & SARFASI mechanism the following additional steps have been taken to address the issue of NPAs:

  a) Creation of a Central Repository of Information on Large Credits (CRILC) by RBI

  b) Formation of Joint Lenders Forum (JLF), Corrective Action Plan (CAP), and sale of assets. - The Framework outlines formation of JLF and corrective action plan that will incentivise early identification of problem cases, timely restructuring of accounts which are considered to be viable, and taking prompt steps by banks for recovery or sale of unviable accounts.

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c) Establishment of six New DRTs

d) Flexible Structuring of Loan Term Project Loans to Infrastructure and Core Industries

- **Empowerment**: The Government has issued a circular that there will be no interference from Government and Banks are encouraged to take their decision independently keeping the commercial interest of the organisation in mind.
- **Framework of Accountability:** A new framework of Key Performance Indicators (KPIs) to be measured for performance of PSBs is being announced. It is divided into four sections relating to efficiency of capital use, diversification of business/processes, NPA management and financial inclusion.
- **Governance Reforms**: Banks have been assured of "no interference policy", but at the same time asking them to have robust grievance redressal mechanism for borrowers, depositors as well as staff.

Related Questions

1. Discuss how the Twin Balance Sheet syndrome has made it necessary for government to look forward to create crowding-in effect on economy? Also analyze, how this would affect the fiscal consolidation targets?
2. Discuss implications of increase in debt/equity ratio for firms? Analyze the performance of Indian corporates on this parameter and identify the underlying reasons?

5 FISCAL FRAMEWORK: THE WORLD IS CHANGING, SHOULD INDIA CHANGE TOO?

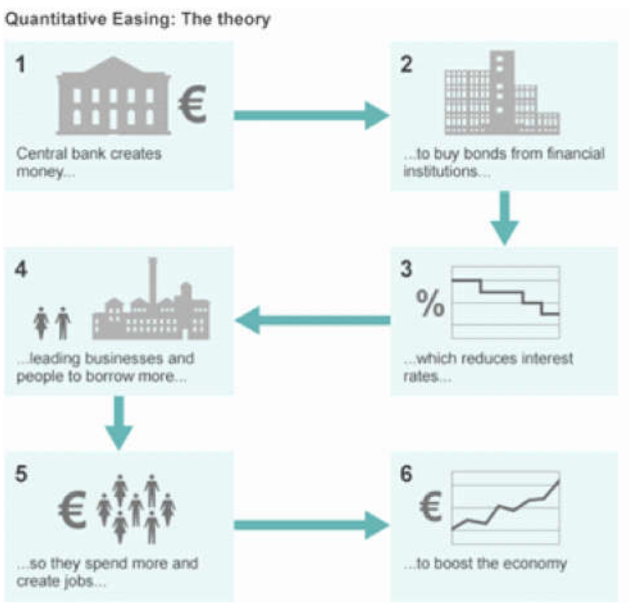
Context

Advanced countries have embraced fiscal activism, giving a greater role to counter-cyclical policies during crisis. But India's experience has taught the opposite lessons increase spending and deficit during accelerating growth lead to financial crisis during 1990's and vulnerability during 2013.On primary deficit front India has been a outlier with high primary deficit vis-à-vis other countries. This means government is dependent on growth and favourable interest rates to contain debt to GDP ratio. Events have reaffirmed the need for rules to contain activism, so as to rein in excessive spending during booms and inordinate deficits during downturns.

Technical Terms

A. Procyclical and Counter Cyclical fiscal Policies - A 'procyclical fiscal policy' can be summarised simply as governments choosing to increase public spending and reduce taxes during an economic boom, but reduce spending and increase taxes during a recession. A 'countercyclical' fiscal policy refers to the opposite approach: reducing spending and raising taxes during a boom period, and increasing spending/cutting taxes during a recession.

B. Fiscal activism: fiscal policies of a government which believes in active participation in the national economy to affect its economic agenda and objectives.



C. Quantitative easing - One of the main tools they have to control growth is raising or lowering interest rates. Lower interest rates encourage people or companies to spend money, rather than save. But when interest rates are at almost zero, central banks need to adopt different tactics - such as pumping money directly into the financial system. Central Bank prints money and then uses this money to buy bonds from investors such as banks or pension funds. This increases the overall amount of useable funds in the financial system. Making more money available is supposed to encourage financial institutions to lend more to businesses and individuals. It can also push interest rates lower across the economy, even when the central bank's own rates are just about as low as they can go. This in turn should allow businesses to invest and consumers to spend more, giving a knock-on boost to the economy.

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Gist of Economic Survey Chapter

The Chapter compare Indian response on fiscal policies of flow (deficit) and stock (debt) compared to other world economies over the period and during time of crisis especially during global financial crisis and what should be India's future fiscal policy framework toward these ends.

In this time of pessimism the advance countries followed fiscal expansionary policies, however even after cyclic conditions are changing, advance economies may favour activist fiscal policies especially in case of USA. In current times, the new view of fiscal policy shifts the emphasis from stocks to flows, arguing for greater activism in flows (deficits) and minimizing concerns about the sustainability of the stocks (debt). Should India follow the same path? This is imperative at a time when India is reviewing the fiscal policy framework enshrined in the FRBM Act of 2003.

India and the World: Flows

As Advanced Economies (AEs) are taking path of activist fiscal policies considering challenges of weak economic activity and the inability to address this problem through monetary policy, India may have the need for counter-cyclic policy due to twine deficit problem and debt overhang.

However India's situation differs from that of the AEs in some important ways which run counter to taking path of activist counter-cyclical policy. This include High growth rate along with substantially high inflation rate,As a result, monetary policy is nowhere close to the zero lower bound.

Apart from it India, India's fiscal stance has an in-built bias toward higher deficits, because spending rises pro-cyclically during growth surges, while revenue and spending are deployed counter-cyclically during slowdowns. The inability to rein in these deficits played a key role in undermining India's external situation which resulted in full blown crisis of 1991 and later crisis of 2013. This pattern creates fiscal fragility. Fiscal rules, insofar as they can be effective and binding, must therefore aim to prevent spending surge during booms and constrain counter-cyclicality during downturns.

India and the World: Stocks

India has stock problem which include high debt-to-GDP ratio compared to many other emerging markets. However its fiscal strength can be accessed by taking fiscal commitment and debt dynamics into consideration.

Regarding fiscal commitment,if fiscal and debt sustainability is about confidence and trust as revealed in the ability and willingness of governments to limit their debt levels and pay them off without disruption than India has a very good record of keeping its debt commitment both internally and externally.

On debt dynamics, the implications for the growth interest rate differential are stark. India would have a favourable growth interest rate differential compared to AEs because of its high growth rate for next 15 years. This is favourable for debt sustainability, however challenge lies in quite high primary deficit that is the shortfall between its receipts and its non-interest expenditures, compared to its peers. As a result of running a primary deficit, the government is dependent on growth and favourable interest rates to contain the debt ratio. This could result in upward spiral of debt ratio if growth rate and interest rates are faltered.

Conclusion

Back in 2003 there was common agreement that fiscal rules were better than discretion, that fiscal policy should be aimed at medium-term objectives such as reducing the stock of debt rather than shorter-term cyclical considerations. Now, advanced countries have moved away from these principles toward greater

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fiscal activism, giving counter-cyclical policies much more of a role and giving correspondingly less weight toward curbing the debt stock. But India's experience has taught the opposite lessons. It has reaffirmed the need for rules to contain fiscal deficits, because of the proclivity to spend during booms and undertake stimulus during downturns. It has also highlighted the danger of relying on rapid growth rather than steady and gradual fiscal and primary balance adjustment to do the "heavy lifting" on debt reduction.

In short, it has underscored the fundamental validity of the fiscal policy principles set out in the FRBM. Even as these basic tenets of the FRBM remain valid, the operational framework designed in 2003 will need to be modifiedto reflect the India of today, and even more importantly the India of tomorrow. This, then, will be the task of the FRBM Review Committee: to set out a new vision, an FRBM for the 21st century.

Supplementary Readings

A. Fiscal Responsibility and Budget Management (FRBM) Act

Indian economy faced with the problem of large fiscal deficit and its monetization spilled over to external sector in the late 1980s and early 1990s. The large borrowings of the government led to such a precarious situation that government was unable to pay even for two weeks of imports resulting in economic crisis of 1991. Consequently, Economic reforms were introduced in 1991 and fiscal consolidation emerged as one of the key areas of reforms. After a good start in the early nineties, the fiscal consolidation faltered after 1997-98. The fiscal deficit started rising after 1997-98. The Government introduced FRBM Act,2003 to check the deteriorating fiscal situation.

FRBM Act provides a legal institutional framework for fiscal consolidation. Fiscal Responsibility and Budget Management (FRBM) became an Act in 2003. The objective of the Act is

- To ensure inter-generational equity in fiscal management
- Long run macroeconomic stability
- Better coordination between fiscal and monetary policy, and
- Transparency in fiscal operation of the Government

The Government notified FRBM rules in July 2004 to specify the annual reduction targets for fiscal indicators. The FRBM rule specifies reduction of fiscal deficit to 3% of the GDP by 2008-09. Similarly, revenue deficit has to be reduced with complete elimination to be achieved by 2008-09. The Government can move away from the path of fiscal consolidation only in case of natural calamity, national security and other exceptional grounds which Central Government may specify. The Finance Minister has to explain the reasons and suggest corrective actions to be taken, in case of breach.

The Act bans the purchase of primary issues of the Central Government securities by the RBI after 2006, preventing monetization of government deficit. The Act also requires the government to lay before the parliament three policy statements in each financial year namely

- Medium Term Fiscal Policy Statement
- Fiscal Policy Strategy Statement and
- Macroeconomic Framework Policy Statement.

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To impart fiscal discipline at the state level, the Twelfth Finance Commission gave incentives to states through conditional debt restructuring and interest rate relief for introducing Fiscal Responsibility Legislations (FRLs). All the states have implemented their own FRLs.

Implementation

The implementation of FRBM Act/FRLs improved the fiscal performance of both centre and states. The States have achieved the targets much ahead the prescribed timeline. Government of India was on the path of achieving this objective right in time. However, due to the global financial crisis, this was suspended and the fiscal consolidation as mandated in the FRBM Act was put on hold in 2007-08.The crisis period called for increase in expenditure by the government to boost demand in the economy. As a result of fiscal stimulus, the government has moved away from the path of fiscal consolidation. However, it should be noted that strict adherence to the path of fiscal consolidation during pre crisis period created enough fiscal space for pursuing counter cyclical fiscal policy.

Amendments to FRBM Act

Through Finance Act 2012, amendments were made to the Fiscal Responsibility and Budget Management Act, 2003 through which it was decided that in addition to the existing three documents, Central Government shall lay another document - the Medium Term Expenditure Framework Statement (MTEF) - before both Houses of Parliament in the Session immediately following the Session of Parliament in which Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement are laid.

Concept of "Effective Revenue Deficit" and "Medium Term Expenditure Framework" statement are the two important features of amendment to FRBM Act in the direction of expenditure reforms. Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. This will help in reducing consumptive component of revenue deficit and create space for increased capital spending. Effective revenue deficit has now become a new fiscal parameter. "Medium-term Expenditure Framework" statement will set forth a three-year rolling target for expenditure indicators.

As per the amendments in 2012, the Central Government has to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit to eliminate the effective revenue deficit by the 31st March, 2015 and thereafter build up adequate effective revenue surplus and also to reach revenue deficit of not more than 2 % of Gross Domestic Product by the 31st March, 2015.

Vide the Finance Act 2015, the target dates for achieving the prescribed rates of effective deficit and fiscal deficit were further extended. The effective revenue deficit which had to be eliminated by March 2015 will now need to be eliminated only after 3 years i.e., by March 2018. The 3% target of fiscal deficit to be achieved by 2016-17 has now been shifted by one more year to March 2018.

Committee to Review the Implementation of the FRBM Act

In the Union Budget 2016-17 it was proposed to constitute a Committee to review the implementation of the FRBM Act and give its recommendations on the way forward. This was in view of the new school of thought which believes that instead of fixed numbers as fiscal deficit targets, it may be better to have a fiscal deficit range as the target, which would give necessary policy space to the Government to deal with dynamic situations. A time has come to review the working of the FRBM Act, especially in the context of the uncertainty and volatility which have become the new norms of global economy.

The FRBM Review Committee has given its report recently. The Committee has done an elaborate exercise and has recommended that a sustainable debt path must be the principal macro-economic anchor of our fiscal policy. The Committee has favoured Debt to GDP of 60% for the General Government by

Notes

2023, consisting of 40% for Central Government and 20% for State Governments. Within this framework, the Committee has derived and recommended 3% fiscal deficit for the next three years.

The Committee has also provided for 'Escape Clauses', for deviations upto 0.5% of GDP, from the stipulated fiscal deficit target. Among the triggers for taking recourse to these Escape Clauses, the Committee has included "far-reaching structural reforms in the economy with unanticipated fiscal implications" as one of the factors. Considering all these aspects, budget 2017-18 has pegged the fiscal deficit for 2017-18 at 3.2% of GDP and 3% in the following year.

Related Questions

1. Rule based fiscal policy is necessary to rationalize fiscal activism both during boom and downturn. Comment
2. What are the merits of using fiscal policy during Crisis? What has been India's experience in this regard?

Notes

6 FISCAL RULES: LESSONS FROM THE STATES

Context

Soon after the introduction of Fiscal Responsibility Legislation (FRL) most states have significantly reduced deficits Comparing average values for 10 years post and 11 years before passing of FSL by states, fiscal deficit has reduced to 2.4% from 4.1% of GSDP. However, the FRL was not the sole impetus behind this impressive fiscal performance.

Acceleration of GDP growth, increased transfers from the Centre, decline in interest payments and increased central CSS expenditure contributed significantly to such consolidation. Desisting from splurging rather than belt-tightening was probably the real contribution of the States.

Fiscal challenges are mounting because of the Pay Commission recommendations, slowing growth, and rising payments from the UDAY bonds. There is a need for some reforms to keep fiscal performance on track. Going forward greater market-based discipline on state government finances will be a major imperative. Secondly, attaching horizontal fiscal devolution with fiscal performance should be reconsidered. And, the Centre must take the lead not only in incentivizing fiscal b prudence by states but also by acting as a model through its own fiscal management.

Technical Terms

A. Various indicators of deficit in the budget are:

- Budget deficit = total expenditure – total receipts
- Revenue deficit = revenue expenditure – revenue receipts
- Fiscal Deficit = total expenditure – total receipts except borrowings (it tells amount of borrowing required)
- Primary Deficit = Fiscal deficit- interest payments
- Effective revenue Deficit-= Revenue Deficit – grants for the creation of capital assets
- Monetized Fiscal Deficit = that part of the fiscal deficit covered by borrowing from the RBI.

B. Intermediate T- bills – T-bills are short term (up to one year) borrowing instruments of the Government of India which enable investors to park their short term surplus funds while reducing their market risk. They are auctioned by Reserve Bank of India at regular intervals and issued at a discount to face value. In 1997, the Government had also introduced the 14-day intermediate treasury bills.

Notes

C. State Guarantee – It is a promise by state government to discharge off the liability of 3rd person in case of default.

D. Spread of Bond - The difference between the yields of two bonds with differing credit ratings. The bond spread will show the additional yield that could be earned from a bond which has a higher risk.

Gist of Economic Survey Chapter

To advance rather than defer the desirable goal of fiscal prudence, India like several other countries, embarked in the mid-2000s on an ambitious project of fiscal consolidation, adopting fiscal rules aimed at curbing fiscal deficits.

The FRBM Act, 2003 (as amended), which became effective from July 5, 2004 mandates the Central Government to eliminate revenue deficit by March, 2009 and to reduce fiscal deficit to an amount equivalent to 3 per cent of GDP by March,2008. The annual targets for fiscal correction were to be specified by rules to be framed under the Act.

This Chapter looks into fiscal discipline of states. Answer to the following questions can provide an analysis to present fiscal condition of states.

- To what extent did the FRL really make a difference – and in what ways?
- What are the other factors which enabled better fiscal management?
- What are the lessons for future fiscal rules?

Summary of the Fiscal Responsibility Legislation (FLR)

The FRL aimed to impose fiscal discipline through a number of mechanisms:

- Fiscal targets included the overall deficit to be contained within 3 percent of GSDP at any point, while the revenue deficit was to be eliminated by 2008/9 (later extended to 2009/10).
- The 12th Finance Commission allowed states to borrow directly from the market, in the hope that investors would also exercise some discipline, by pushing up interest rates on states whose fiscal position had not improved.
- States were required to publish annual Medium-Term Fiscal Policy reports, which would project deficits over the next three to four years, accounting for growth in big ticket expenditure items like pension liabilities.
- The fiscal deficit target was relaxed temporarily to 3.5 percent of GSDP in 2008/9 and to 4 percent of GSDP in 2009/10 in light of the global financial crisis (RBI, 2010). By FY 2010, the targets were set to the original FRL level of 3 percent.
- Subsequently, the 14th Finance Commission (FFC) recommended that fiscal deficit limits were to be relaxed by 0.5 percentage points for states which meet three conditions:
    1. Zero revenue deficit in the previous year;
    2. Debt to GSDP ratio lower than 25 percent; and
    3. Interest payments to GSDP ratio less than 10 percent of GSDP.

To what extent did the FRL really make a difference – and in what ways?

Since 2005, after introduction of FLR, almost all sates made considerable improvement in their fiscal parameters like fiscal deficit, revenue deficit, primary balance and debt to GDP ratio.

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- To access the impacts of FLR we need to exclude the exogenous factors and their impact on fiscal conditions of states. For this impact need to measure in FLR time (based on the number of years before or after the particular FRL was adopted).
- Centre also gave incentive for states to adopt fiscal rules and to enablethem to achieve these fiscal targets; the central government provided a conditional debt restructuring window, the Debt Consolidation and Restructuring Facility (DCRF). So states could substantially lower their interest payments in the same year that they adopted the FRL.
- The change in deficits and other fiscal indicators in FRL time should consequently be seen as a result of both the FRL targets as well as the debt restructuring facility.

Impact of FLR

- Within the first two years, states on average lowered their deficits to target levels — 3 percent for fiscal deficit and 0 for revenue deficits – while the primary balance shifted into surplus.The average debt to GSDP ratio accordingly fell by 10 percentage points to a mere 22 percent of GSDP in 2013.
- This progress has proved reasonably durable.
- States kept a tight rein on wage and salary expenditure. Instead, they expanded more discretionary spending, which would be easier to scale back if needed to achieve the deficit targets.
- On two parameters of Off Budget Expenditure i.e. explicit guarantees by state government and borrowing by state PSUs; in the first three years after FRL adoption the flow of explicit guarantees actually turned negative, however after three years, states began to add guarantees, at about the same pace as before. It is therefore encouraging that FFC recommended the notion of "extended debt", which includes guarantees to public sector enterprises; borrowing by state utilities also fell after the FRL from 4.3 percent of GSDP to 3.4 percent of GSDP mainly due to major debt restructuring agreement in 2002/03.
- On budget process States were able to generate accurate forecasts of revenues and expenditures.
- States cash balances rises i.e. holding of Intermediate Treasury Bills (ITBs) have accordingly increased from 0.9 percent of GSDP to 1.3 percent of GSDP between 6 years before and 10 years after the FRL to smooth their expenditure in case of delay of centre transfers.
- FLR encouraged states to prevent from spending their entire windfall.

Why Primary deficit did not improve after FLR?

The primary deficit does not exhibit a significant decrease even in the first two years and in fact rises in later years. This is consistent with the hypothesis that the major decreases in the fiscal deficit came from the reduction in interest payment – which suggest decreased significantly in the first two years by 0.3 percentage points.

What are the other factors which enabled better fiscal management?

Though after 2005, fiscal indicators improved significantly. Yet just because fiscal progress followed the introduction of the FRL doesn't mean the FRLs were entirely responsible for this progress. To begin with, the deficit reduction owes much too favourable exogenous factors:

- An acceleration of nominal GDP growth (of 6 percentage points on average) helped boost states' revenues by about 1 percent of GSDP;

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- Increased transfers from the centre of about 1 percent of GSDP both because of the 13th Finance Commission recommendations and the surge in central government revenues;
- Own tax revenues as a percent of GSDP increase by 1 percentage point, largely due to high GDP growth and adoption of VAT.
- Reduced interest payments of about 0.9 percent of GSDP on account of the debt restructuring package offered by the centre; and
- Reduced need for spending by the states—estimated at about 1.2 percent of GDP—as the centre took on a number of major social sector expenditures under the Centrally Sponsored Schemed.

What are the lessons for future fiscal rules?

The uniqueness or one-off character of the FRL experience is suggested by the relatively quick "decay." That is, a few years after the FRL, all indicators of fiscal performance—deficits, expenditures, and especially off-budget activities—started deteriorating. As the fiscal challenges mount for the states going forward because of the Pay Commission recommendations, slowing growth, and mounting payments from the UDAY bonds, there is need to review how fiscal performance can be kept on track.

- There may need to be greater reliance on incentivizing good fiscal performance i.e. The Fourteenth Finance Commission (FFC) attempted to shift toward incentives by relaxing some of the FRL limits for better-performing states.
- Incentive mechanism deployed by the Thirteenth Finance Commission (TFC) of allocating resources across states (the so-called "horizontal" criteria) based on states' own fiscal performance (proxy by own tax revenue collections) need to be revived.
- Greater market-based discipline on state government finances is imperative. Spread on state government bonds should be correlated with their debt or deficit positions.
- Incentivizing good performance by the states will require the centre to be an exemplar of sound fiscal management itself.

Supplementary Readings

A. Difference between Central Sector and Centrally Sponsored Scheme

In India's developmental plan exercise we have two types of schemes viz; central sector and centrally sponsored scheme. The nomenclature is derived from the pattern of funding and the modality for implementation. Under Central sector schemes, it is 100% funded by the Union government and implemented by the Central Government machinery. Central sector schemes are mainly formulated on subjects from the Union List. In addition, the Central Ministries also implement some schemes directly in States/UTs which are called Central Sector Schemes but resources under these Schemes are not generally transferred to States.

Under Centrally Sponsored Scheme (CSS) a certain percentage of the funding is borne by the States in the ratio of 50:50, 70:30, 75:25 or 90:10 and the implementation is by the State Governments. Centrally Sponsored Schemes are formulated in subjects from the State List to encourage.

B. The States' Debt Consolidation and Relief Facility 2005-2010

Twelfth Finance Commission (TFC) has recommended a two fold strategy for fiscal consolidation and elimination of revenue deficit of the States.

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Central Loans to States contracted till March, 31, 2004 and outstanding on March 31, 2005 may be consolidated and rescheduled for a fresh term of 20 years (resulting in repayment in 20 equal instalments) and an interest of 7.5 percent be charged on them.

The general debt relief, as stated above, comprising consolidation, reschedulement and lowering of interest rate shall be available to the States with effect from the year they enact Fiscal Responsibility and Budget Management legislation.

TFC has also framed a scheme of debt waiver based on fiscal performance linked to the reduction of revenue deficits and control of fiscal deficit of the States. In effect if the revenue deficit is brought down to zero, the entire repayments during the award period of TFC will be written off.

C. Relevant Recommendations of 14th Finance commission (FFC)

The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows:

i. Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this, if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year.

ii. States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.

If a State is not able to fully utilise its sanctioned borrowing limit of 3 per cent of GSDP in any particular year during the first four years of award period (2015-16 to 2018-19), it will have the option of availing this un-utilised borrowing amount (calculated in rupees) only in the following year but within award period.

In order to accord greater sanctity and legitimacy to fiscal management legislation, FFC urge the Union Government to replace the existing FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation, specifically invoking Article 292 in its preamble. This could be an alternative to amending the existing FRBM Act as proposed. FFC urge the State Governments also to consider similar enactments under Article 293(1).

Related Questions

1. Highlight the salient features of FLR. Also examine the role of Fiscal Responsibility Legislation (FLR) in fiscal management of states. Does it made a significant impact?
2. Though fiscal indicators improved significantly, since adoption of FLR, yet it does not mean it was entirely responsible for this progress. Examine the sentence in light of improvement in fiscal management of states. Also suggest, what are the lessons for future fiscal rules?

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7 CLOTHES AND SHOES: CAN INDIA RECLAIM LOW SKILL MANUFACTURING?

Context

Context: India on one hand celebrates it's favourable demographic dividend, however it fails terribly short in providing good jobs to its labor force. Hence taking cue from the success of China and other East Asian countries, who significantly benefitted from high labor intensive and low skill manufacturing sectors like Apparel and footwear, India must gear up with all policy measures such as subsidization, tax reform, labor law reform and favourable trade agreement, to seize the narrow window of opportunity, especially when it's south Asian competitors are battle ready to fill the vacancy created by China in recent times(owing to its increasing labor cost).

Technical Terms

A. **Labour Intensity:** Number of jobs created per unit investment (rs 1lak).Measured for different sectors. e.g. Apparel sector generates 80 time more jobs than Auto sector for similar investment.

B. **Female Labour Intensity:** Number of female jobs created per unit capital investment(Rs. 1 lac).The more female labor intensive a sector is, the more is its potential for social transformation through women empowerment and financial inclusion.

C. **Labour Force participation rate:** The section of working population in the age group of 16-64 in the economy currently employed or seeking employment. People who are still undergoing studies, housewives and persons above the age of 64 are not reckoned in the labour force.

D. **Low wage Employees:** Wage less than Rs20000/month.

E. **Free Trade Agreement:** Such agreements involve cooperation between at least two countries to reduce trade barriers - import quotas and tariffs - and to increase trade of goods and services with each other.

F. **Least developed Countries (LDC):** The Least Developed Countries (LDC) is a list of the countries that, according to the United Nations, exhibit the lowest indicators of socio-economic development, with the lowest Human Development Index ratings of all countries in the world. A country is classified among the Least Developed Countries if it meets three criteria

- Poverty - adjustable criterion based on GNI per capita averaged over three years. As of 2015 a country must have GNI per capita less than US $1,035 to be included on the list, and over $1,242 to graduate from it.
- Human Resource weakness based on indicators of nutrition, health, education and adult literacy and
- Economic vulnerability: based on instability of agricultural production, instability of exports of goods and services, economic importance of non-traditional activities, merchandise export

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concentration, handicap of economic smallness, and the percentage of population displaced by natural disasters.

Gist of Economic Survey Chapter

Introduction

Creating jobs is India's central challenge to achieve social transformation, which can be done by:

- Generating rapid economic growth
- Nurturing an enabling environment for investment is another; and
- Targeted action yet another.

Related to the latter, India needs to generate jobs that are

- Formal and productive,
- Provide bang-for-buck in terms of jobs created relative to investment,
- Have the potential for broader social transformation, and
- Can generate exports and growth.

The apparel and leather and footwear sectors meet many or all of these criteria and hence are eminently suitable candidates for targeting.

Why Clothes and Shoes?

Apparel and footwear sector offer a lot of opportunities which other sector does not. These are:

a) Growth and exports

There is a linkage between GDP growth rates and export growth rates of these two sectors, as was seen in East Asian countries.

- Take-off in economic growth in East Asia has been associated with rapid expansion in clothing and footwear exports in the early stages.GDP growth rate of around 7-10% was associated with around 20% (in some cases 50%) for apparel and 25% for footwear growth in exports of these two sectors.
- India has underperformed in these sectors, especially in leather sector during its take-off stage.

b) Jobs, especially for women

Apparels and Leather sectors offer tremendous opportunities for creation of jobs, especially for women.

- Apparel sector is the most labor-intensive, followed by footwear.
- Apparels are 80-fold more labor-intensive than autos and 240-fold more jobs than steel. The comparable numbers for leather goods are 33 and 100, respectively.
- With rapid exports growth about half a million additional direct jobs can be generated annually.
- The opportunity created for women implies that these sectors could be vehicles for social transformation. Women in Bangladesh, female education, total fertility rates, and women's labour force participation moved positively due to the expansion of the apparel sector.

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c) A historic opportunity - China vacating space filled by others and not India!

- India has an opportunity to promote apparel, leather and footwear sectors because of rising wage levels in China.

	Year	Monthly Wages (USD)
Andhra Pradesh	2016	81
Bihar	2016	84
Odisha	2016	86
Jharkhand	2016	90
Tamil Nadu	2016	93
Uttar Pradesh	2016	95
Karnataka	2016	105
West Bengal	2016	109
Gujarat	2016	114
Madhya Pradesh	2016	115
Maharashtra	2016	118
Haryana	2016	119
Bangladesh	2013	80-120
Vietnam	2015	180- 250
China	2013	250 - 300
Indonesia	2013	120 - 150

Source: ILO, State Labour Departments

- India is well positioned to take advantage of China's deteriorating competitiveness because wage costs in most Indian states are significantly lower than in China.

But the space vacated by China is fast being taken over by Bangladesh and Vietnam in case of apparels; Vietnam and Indonesia in case of leather and footwear, even Indian companies are relocating to these countries and Myanmar. India has to act fast if it does not want to lose in race.

Challenges

India still has potential comparative advantage in terms of cheaper and more abundant labour. But these are nullified by other factors that render them less competitive than their peers in competitor countries.

The Apparel and Leather sectors face a set of common challenges, which are:

a) Logistics

- The costs and time involved in getting goods from factory to destination are greater than those for other countries
- Further, few Very Large Capacity Containers (VLCC) come to Indian ports to take cargo so that exports have to be trans shipped through Colombo which adds to travel costs and hence reduces the flexibility for manufacturers.

Notes

b) Labour regulations

- Regulations on minimum overtime pay: There are strict regulations for overtime wage payment as the Minimum Wages Act 1948 mandates payment of overtime wages at twice the rate of ordinary rates of wages of the worker.
- Lack of flexibility in part-time work and high minimum wages in some cases.
- Onerous mandatory contributions that become de facto taxes for low-paid workers in small firms that results in a 45 per cent lower disposable salary.

One symptom of labour market problems is that Indian apparel and leather firms are smaller compared to China, Bangladesh and Vietnam, with 78% of firms employing less than 50 workers (same is just 15% in China).

c) Tax & tariff policy

- Globally demand is shifting towards man-made fibers, but Indian taxation (7.5% tax on cotton bases products and 8.4% tax on man-made products) and tariff policy (10 percent tariff on man-made fibers v/s 6 percent on cotton fibers.) Discriminates against it and favors cotton based exports.
- High tariffs on yarn and fiber increase the cost of production in clothing. Though duty drawback for tariffs on inputs is available, but that excludes purchase of domestically produced yarn and domestic sale making and thus making such Indian products un-competitive.
- A similar problem also afflicts footwear production with taxes of 20.5 per cent on leather and 27 per cent on non-leather footwear. There is a need for rationalization of these policies.

Globally demand in footwear industry is shifting from leather based to non-leather based, because of physical comfort, aesthetics and price affordability and various other factors. India has good share in leather based exports and must shift to non-leather footwear if it wants to gain from China's slowdown in exports, which occupies important place in this segment.

d) Disadvantages emanating from the international trading environment compared to competitor countries.

- India's competitor exporting nations for apparels and leather and footwear enjoy better market access by way of zero or at least lower tariffs in the two major importing markets, namely, the United States of America (USA) and European Union (EU). Bangladesh and Ethiopia, both emerging as major exporters and having significant share, have zero tariffs in case of apparel, whereas India will face 9.1% tariff in EU and 11.4% in US. Same is the case with footwear sector.
- An FTA with EU, UK can help India offset existing disadvantages in apparel sector and getting relative advantages in footwear sector.

e) Sector specific challenge

- Globally cattle bases leather products are preferred as compared to buffalo, goat or other animal based. But in India despite availability of large cattle population very less cattle is available for slaughter.

Responses needs

Several steps have been taken for textile and apparel sector:

- Apparel exporters will be provided relief to offset the impact of state taxes embedded in exports, which could be as high as about 5 per cent of exports.

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- Textile and apparel firms will be provided a subsidy for increasing employment in the form of government contributing the employers' 12 per cent contribution to the Employee Provident Fund (EPF).

But all these need to be complemented by further actions:

- FTAs with EU and UK must be negotiated after carefully weighing cost and benefits, with special focus on apparel and footwear sector and jobs in this sector.
- Introduction of GST will help in rationalization of taxes and removal of tax related disadvantage against man-made fiber based apparel and non-leather footwear.
- Third, a number of labor law reforms would overcome obstacles to employment creation in these sectors. Statutory deductions like Employee Provident Fund Organization (EPFO), Employee Pension Scheme (EPS), Employee State Insurance (ESI) etc. for low wage employees (salary less than Rs. 20,000/month) accounts to around 45%, which has been questioned on various accounts like:
  - Low wage employees do not have a 45% saving rate, therefore would like to have money in hand rather than statutorily deducted.
  - EPFO and ESI have many accounts with unclaimed balances. EPFO fees are also very high.

All these create hindrances in path of formalization of jobs in the sector. Formal employment could increase by offering employees three choices when they start employment:

- Decide whether they want 12 per cent employee contribution to be deducted;
- Decide whether their 12 per cent employer contribution goes to EPFO or National Pension Scheme (NPS);
- Decide whether their health insurance premiums go to ESI or a private health insurance of the employee's choice.

All these choices should be exercised on the part of employee, thus giving him greater choice.

Conclusion

All industrial policy aimed at promoting a particular sector is not without risks. But the externality generating attributes-employment, exports, social transformation - of the apparel and footwear sectors, India's potential comparative advantage in it, and the narrow window of opportunity available, make the risk worth taking. And, in any case, many of the proposed policy responses such as FTAs, tax rationalization, and labour law reform could have wider, economy-wide benefits.

Supplementary Readings

Apparel and Footwear sector in emerging economy

In apparel and footwear, the differences between emerging and developed markets are significant. Developed markets reported value and volume growth of 2 per cent, while emerging markets witnessed value growth of 8 per cent and volume at 3 per cent in apparel and footwear during 2015. Consumers remain cautious in developed markets as economic growth appears fragile, additionally, wider availability of trend-led products at low prices and impressive growth in e-commerce continue to impact unit prices and value growth. In contrast, emerging markets are benefiting from rising disposable incomes and aspirational purchases.

Notes

India is the second largest footwear producer in the world, with footwear production accounting for approximately 9 per cent of the global annual production - 22 billion pairs as compared to China, which produces over 60 per cent of the global production.

India annually produces 2.1 billion pairs of which 90 per cent are consumed internally while remaining are exported primarily to European nations which include United Kingdom, Germany, USA, Italy and France.

Footwear exports from India have grown at a CAGR of 20 per cent in Indian Rupee terms during the last five year backed by growing demand from European nations and increasing focus of main importing countries to shift sourcing from China to other low cost producing countries.

India is the third largest footwear consuming country in the world after China and USA, but with very little separating the three, India is very soon expected to be the second largest consumer as well.

In absolute terms, footwear exports from India have risen from Rs. 71.5 billion in FY10 to Rs. 180.0 billion in FY15.

The growth in Indian fashion and lifestyle market has given an impetus to the footwear industry as well. From a basic need-based industry, it has become an evolving fashion and style category.

The unorganised segment gains prominence in the Indian context due to its price-competitive products, which are more suitable and attractive to the price conscious Indian consumer. But with increased household income, shifting consumer behaviour from saving to spending, increasing brand consciousness amongst Indian consumers, influx of large number of global brands and penetration in tier - II and III cities by footwear companies, the organised retail in footwear market is rapidly evolving and expected to grow at a higher rate in the future.

The rural market of India is still largely untapped for footwear manufacturers. Companies are re-positioning themselves and launching specific products and price ranges to expand their presence and increase their consumer base in rural areas.

Related Questions

1. Discuss the employment scenario in India .How can low skill manufacturing sector address the issue of employment?
2. What are the challenges faced by Textile sector in general and apparel sector in particular. Enumerate government initiatives to promote these sectors.

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8 REVIEW OF ECONOMIC DEVELOPMENT

Context

The GDP has grown at 7.1 per cent in the first half of the current financial year, as per the estimates released by the Central Statistics Office (CSO). The first advance estimates released in early January 2017 were arrived at mainly based on data prior to demonetisation and largely re?ect the economic situation prevailing in the first seven to eight months of the financial year.

At the sectoral level, growth of agriculture & allied sectors improved significantly in 2016-17, following the normal monsoon in the current year which was preceded by sub-par monsoon rainfall in 2014-15 and 2015-16. The growth in industrial sector, comprising mining & quarrying, manufacturing, electricity, gas & water supply, and construction sectors moderated in 2016-17. This is in tandem with the moderation in manufacturing, mostly on account of a steep contraction in capital goods, and consumer non-durable segments. As in the previous years, the service sector continued to be the dominant contributor to the overall growth of the economy, led by a significant pick-up in public administration, defence & other services, that were boosted by the payouts of the Seventh Pay Commission.

The headline in?ation as measured by the Consumer Price Index (CPI) remained under control for the third successive financial year as a result of lower prices especially of food items. This is because Since July 2016, pulses prices except gram dal prices have been declining owing to near normal monsoon, increase in the Rabi pulses sowing and buffer build up by the Government.

At the monetary front credit growth is the major issue which require solving twin balance sheet problem. Also, RBI has accepted many recommendations of Khan Committee to strengthen corporate bond market.

The trend of negative growth was reversed somewhat during 2016-17 (April-December), with exports registering a growth of 0.7 per cent. Despite moderate growth in exports, India's external sector position has been comfortable, with the current account deficit (CAD) progressively contracting from US$ 88.2 billion (4.8 per cent of GDP) in 2012-13 to US$ 22.2 billion (1.1 per cent of GDP) in 2015-16. The CAD further narrowed in 2016-17 (H1) to 0.3 per cent of GDP.

The downward spiral in international crude oil prices resulted in a decline in oil import bill by around 18 per cent which together with a sharp decline in gold imports led to a reduction in India's overall imports. Robust in?ow of foreign direct investment (FDI) and net positive in?ow of foreign portfolio investment (FPI) were sufficient to finance CAD leading to an accretion in foreign exchange reserves.

As per the Reserve Bank of India data, expenditure on social services by Centre and States, as a proportion of GDP was 7.0 per cent during 2016-17 (BE), with education and health sectors accounting for 2.9 per cent and 1.4 per cent respectively. There

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is a clear shift in employment to secondary and tertiary sectors from the primary sector. On the other hand growth in employment re?ects increases in both casual labour and contract workers. Overall, As per EUS Surveys, employment growth has been sluggish. The multiplicity of labour laws and the difficulty in their compliance have been an impediment to the industrial development and employment generation.

An important concern that is often raised in the context of school education is low learning outcomes. This has been pointed out in several studies including ASER, 2014. While there have been improvements in access and retention, the learning outcomes for a majority of children

is still a cause of serious concern. Some of the underlying causes contributing to low quality of education in the primary sector are teacher absenteeism and the shortage of professionally qualified teachers.

However, challenges abound. The investment to GDP ratio has not only been lower than the desirable levels but has been consistently declining over the last few years. This trend needs to be reversed at the earliest in order to realise higher and lasting economic growth. Similarly, the savings rate will have to be raised, so that investment can be financed without resorting to high dose of external financing. After remaining fairly stable for much of the last two years, international prices of crude oil have started to trend up. This along with rise in the prices of other commodities like coal, etc. could exert in?ationary pressure and have the potential to adversely impact the trade and fiscal balances. The outlook for the next financial year suggests that growth is set to recover, as the currency in circulation returns to normal levels and taking into account the significant reform measures initiated by the government

Technical Terms

A. **A. Gross fixed capital formation (GFCF) -** It refers to the net increase in physical assets (investment minus disposals) within the measurement period. GFCF is called "gross" because the measure does not make any adjustments to deduct the consumption of fixed capital (depreciation of fixed assets) from the investment figures. It also does not include land purchases. It is a component of expenditure approach to calculating GDP.

B. **Base Effect -** inflation is calculated taking into account index number for present month and corresponding month in the previous year i.e. index figures for july this year and july last year and not july this year and june this year).

$$\text{Current Inflation Rate} = \frac{(\text{Current Price} - \text{Last year's Price Index})}{\text{Last years's Price Index}} \quad 100$$

The base effect refers to the impact of the rise in price in the previous year level (i.e. last year's inflation) over the corresponding rise in price levels in the current year (i.e., current inflation): if the price index had risen at a high rate in the corresponding period of the previous year leading to a high inflation rate, some of the potential rise is already factored in, therefore a similar absolute increase in the Price index in the current year will lead to a relatively lower inflation rates. On the other hand, if the inflation rate was too low in the corresponding period of the previous year, even a relatively smaller rise in the Price Index will arithmetically give a high rate of current inflation.

Notes

C. **Liquidity Adjustment Facility (LAF) -** Liquidity Adjustment Facility (LAF) is the primary instrument of Reserve Bank of India for modulating liquidity and transmitting interest rate signals to the market. It refers to the difference between the two key rates viz. repo rate and reverse repo rate. Informally, Liquidity Adjustment Facility is also known as Liquidity Corridor.

Under Repo, the banks borrow money from RBI to meet short term needs by putting government securities (G-secs) as collateral (which are not a part of SLR). Under Reverse Repo, RBI borrows money from banks by lending securities. While repo injects liquidity into the system, the Reverse repo absorbs the liquidity from the system. RBI only announces Repo Rate. The Reverse Repo Rate is linked to Repo Rate and is 100 basis points (1%) below repo rate. RBI makes decision regarding Repo Rate on the basis of prevalent market conditions and relevant factors. The tenure of the Repo is seven working days.

D. **Marginal Standing Facility (MSF) -** It is a new Liquidity Adjustment Facility (LAF) window created by Reserve Bank of India in its credit policy of May 2011. MSF is the rate at which the banks are able to borrow overnight funds from RBI against the approved government securities (which can be a part of SLR). Overall idea behind the MSF is to contain volatility in the overnight inter-bank rates. Rate of Interest The rate of interest on MSF is above 100 bps above the Repo Rate.

E. **Market stabilisation scheme (MSS) bonds -** These are special bonds floated on behalf of the government by the RBI for the specific purpose of mop ping up the excess liquidity in the system when regular government bonds prove inadequate. These are mostly shorter-tenure bonds, of less than six months maturity. But the tenure differs depending on the requirement. The sudden surge in deposits due to the surrender of demonetised currency notes in large quantities skews bond yields and interest rates, disrupting the functioning of the market. To impound the excess liquidity, bankers felt MSS bonds were a better option than a hike in CRR holdings.

F. **Nominal Effective Exchange Rate -** The nominal effective exchange rate (NEER) is an unadjusted weighted average rate at which one country's currency exchanges for a basket of multiple foreign currencies i.e. It is the value of basket of foreign currencies in terms of Indian rupee. If NEER value is high then other country currency could buy more of Indian products then exports would increase. In economics, the NEER is an indicator of a country's international competitiveness.

G. **Real Effective Exchange Rate -** The real effective exchange rate (REER) is the weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.

H. **Index of Industrial production -** Index of Industrial Production (IIP) measures the quantum of changes in the industrial production in an economy and captures the general level of industrial activity in the country. It is a composite indicator expressed in terms of an index number which measures the short term changes in the volume of production of a basket of industrial products during a given period with respect to the base period. IIP is a short term indicator of industrial growth till the results from Annual Survey of Industries and National Accounts Statistics are available. The base year is always given a value of 100. The current base year for the IIP series in India is 2004-05. So, if the current IIP reads as 116 it means that there has been 16% growth compared to the base year. Index of Industrial Production is compiled and published every month by Central Statistics Office (CSO) of the Ministry of Statistics and Programme Implementation with a time lag of six weeks from the reference month.

I. **Emission Intensity of GDP -** Emission intensity is the volume of emissions per unit of GDP. Reducing emission intensity means that less pollution is being created per unit of GDP.

Notes

J. **Green Energy Corridor -** The Government in 2013 announced a National Green Corridor Program (NGCP) worth Rs. 43,000 Crore to enable the flow of renewable energy into the National Grid Network. Specifically, the green energy corridor is grid connected network for the transmission of renewable energy produced from various renewable energy projects.

K. **National Adaptation Fund on Climate Change (NAFCC) -** The National Adaptation Fund on Climate Change (NAFCC) has been established in August 2015 to meet the cost of adaptation to climate change for the State and Union Territories of India that are particularly vulnerable to the adverse effects of climate change. Government has set up a budget provision of Rs.350 crores for the year 2015-16 and 2016-17, with an estimated requirement of Rs.181.5 crores for financial year 2017-18 for NAFCC. The projects under NAFCC prioritize the needs that builds climate resilience in the areas identified under the SAPCC (State Action Plan on Climate Change) and the relevant Missions under NAPCC (National Action Plan on Climate Change).

Gist of Economic Survey Chapter

Indian Economy GDP and GVA growth rate

- As per the first Advance Estimates by CSO, **GDP growth rate** is estimated at **7.1%** in 2016-17.
- The growth in the second half of 2016-17 works out to 7.0 per cent as against 7.2 per cent in the first half. However, estimates of second half are based on the economic situation prior to the demonetisation.

Growth Rate of GVA at Basic Prices for Different Sectors (per cent)

Sector	2012-13[a]	2013-14[a]	2014-15[b]	2015-16[c]	2016-17[d]	2016-17	
						H1	H2
Agriculture, forestry & fishing	**1.5**	**4.2**	**-0.2**	**1.2**	**4.1**	**2.5**	**5.2**
Industry	**3.6**	**5.0**	**5.9**	**7.4**	**5.2**	**5.6**	**4.9**
Mining & quarrying	-0.5	3.0	10.8	7.4	-1.8	-0.9	-2.6
Manufacturing	6.0	5.6	5.5	9.3	7.4	8.1	6.7
Electricity, gas, water supply, etc	2.8	4.7	8.0	6.6	6.5	6.4	6.6
Construction	0.6	4.6	4.4	3.9	2.9	2.5	3.4
Services	**8.1**	**7.8**	**10.3**	**8.9**	**8.8**	**9.2**	**8.4**
Trade, hotel, transport, storage	9.7	7.8	9.8	9.0	6.0	7.6	4.5
Financial, real estate & professional services	9.5	10.1	10.6	10.3	9.0	8.8	9.2
Public administration, defence, etc.	4.1	4.5	10.7	6.6	12.8	12.4	13.2
GVA at basic prices	**5.4**	**6.3**	**7.1**	**7.2**	**7.0**	**7.2**	**6.7**

Source: CSO
Note: a=second revised estimate; b=first revised estimate c=provisional estimate; d= first advance estimate

- The growth rate of **Gross Value Added (GVA)** at constant basic prices for 2016-17 is placed at **7.0 per cent,** as against 7.2 per cent in 2015-16.
- The growth in the second half of 2016-17 is estimated at 6.7 per cent as against 7.2 per cent in the first half.

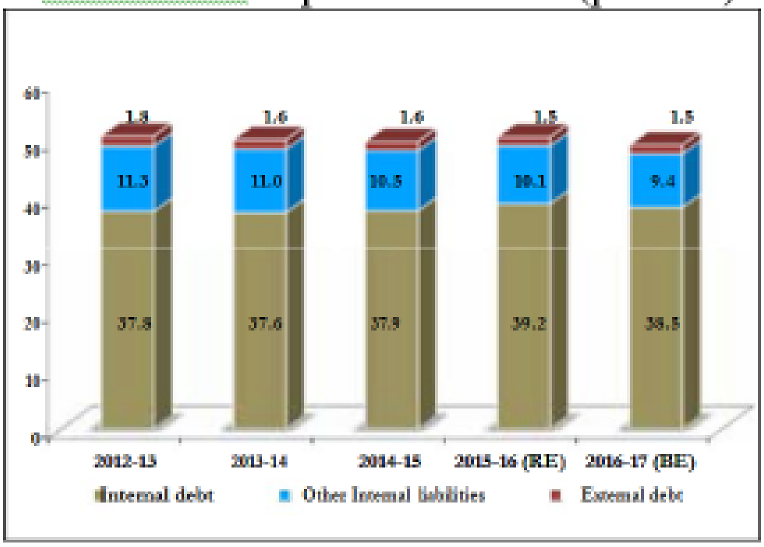
Notes

- In various sector, **growth in Agriculture and allied sector is estimated at 4%** on account of better monsoon compared last two years.
- However, growth in Industrial sector is slowing down on account of moderation in manufacturing mainly due to a steep contraction in capital goods, and consumer non-durable segments of **Index of Industrial Production (IIP)**. Contraction in mining because of slowdown in production of crude oil and gas is also adding to it.
- **Growth in service sector** would be continued to near 9% led by a significant pick-up in public administration, defence & other services that were boosted by the pay-outs of the Seventh Pay Commission.
- **Gross fixed capital formation (GFCF) to GDP ratio (at current prices)** is estimated to be **26.6 per cent**. Fixed investment rate has been declining since 2011-12. However, the growth in government final consumption expenditure that is the major driver of GDP growth in the current year from the demand side. Import and export both are shrinking.

Fiscal developments

- **Fiscal deficit for 2016-17 was projected to be 3.5%,which was sought to be achieved through an 11.9 per cent increase in the gross tax revenue** (mainly due to growth in union excise duties and service Tax) and significant strides in non-tax revenue and non-debt capital receipts.
- However, growth in revenue expenditure during April-November 2016, which prima facie seems very high, as the salary component increased by 23.2 on recommendation of **the Seventh Pay Commission,** a 21.6 per cent surge in food subsidy and an increase of 39.5 per cent in **the grants for creation of capital assets** (GCCA) during April-November 2016.
- The growth in the total outstanding liabilities of the Union Government remained closely similar during 2014-15 and 2015-16, at 10.1 per cent and 10.4 per cent respectively, yet there was an increase in the ratio of internal debt of the Central Government to GDP in 2015-16 mainly because of decline in nominal GDP on account of sharp decline in inflation.

Outstanding liabilities of the Union Government as per cent of GDP (per cent)



Source: CGA
Note: RE- Revised estimates

Inflation

- The headline inflation as measured by the **Consumer Price Index** (CPI) remained under control for the third successive financial year i.e. 4.8% in 2016-17, 4.9 per cent in 2015-16 and5.9 per cent in 2014-15 mainly due to decline in food items.
- The average inflation based on the **wholesale price index** (WPI) declined to (-) 2.5per cent in 2015-16 from 2.0 per cent in 2014- 15 however trend reversed in 2016 with average inflation was 2.9 per cent during April- December 2016 mainly due to impact of rise in global commodity prices, energy price and partly owing to adverse base effect.
- The inflation in India is repeatedly being driven by narrow group of food items. Prices of pulses which remain high till mid July 2016 was major contributor to inflation which declined afterward owing to near normal monsoon, increase in the Rabi pulses sowing and buffer build up by the Government.
- However CPI based core inflation (exclusive of food and fuel group) has remained near 4.8% so far during this fiscal year. For the next financial year, the recent uptick in global commodity prices, in particular crude oil prices, pose an upside risk.

Monetary Management and Financial intermediation

- The Government amended the Reserve Bank of India Act, 1934 during the current financial year which provide for inflation target to be set by the Government in consultation with the Reserve Bank, once in every five years and further provides for a statutory basis for the constitution of an empowered **Monetary Policy Committee** (MPC) to set the policy rates.
- The Government has fixed the inflation target of 4 per cent with tolerance level of +/- 2 per cent for the period beginning from 5th August, 2016 to March 31, 2021.
- The MPC reduced the policy rate by 25 basis points to 6.25 per cent in its first meeting held on October 4, 2016. Hence the reverse repo rate under the Liquidity Adjustment Facility (LAF) remains 5.75 per cent, and the Marginal Standing Facility (MSF) rate is 6.75 per cent.
- The asset quality of banks deteriorated further. The gross non-performing assets (GNPA) to total advances ratio of scheduled commercial banks (SCBs) increased to 9.1 per cent from 7.8 per cent between March and September 2016.
- **Non- food credit** (NFC) outstanding grew at sub 10 per cent for all the months except for September 2016, Credit growth to industrial sector remained persistently below 1 per cent during the current fiscal, However, bank credit lending to agriculture and allied activities (A&A) and personal loans (PL) segments continue to be the major contributor to overall NFC growth.

Measures to strengthen corporate bond market

The RBI took a number of measures to strengthen the corporate bond market in India. It accepted many of the recommendations of the Khan Committee to boost investor participation and market liquidity in the corporate bond market.

- Commercial banks are permitted to issue rupee-denominated bonds overseas (masala bonds) for their capital requirements and for financing infrastructure and affordable housing;
- Brokers registered with the SEBI and authorized as market makers in corporate bond market permitted to undertake repo / reverse repo contracts in corporate debt securities. This move will make corporate bonds fungible and thus boost turnover in the secondary market;

Notes

- Banks allowed increasing the partial credit enhancement they provide for corporate bonds to 50 per cent from 20 per cent. This move will help lower-rated corporate to access the bond market;
- Permitting primary dealers to act as market makers for government bonds, to give further boost to government securities by making them more accessible to retail investors;
- To ease access to the foreign exchange market for hedging in over the counter (OTC) and exchange-traded currency derivatives, the RBI has allowed entities exposed to exchange rate risk to undertake hedge transactions with simplified procedures, up to a limit of US$30 million at any given time.

India's Merchandise Trade

- The trend of negative growth was reversed somewhat during 2016-17 (April-December), with exports registering a growth of 0.7 per cent to US$ 198.8 billion from US$ 197.3 billion in 2015-16 mainly due to growth in Non POL (Petroleum, oil and lubricants) exports (April-December).
- Region-wise, India's exports to Europe, America and Asia increased by 2.6 per cent, 2.4 per cent and 1.1 per cent respectively in 2016-17 (April- November), while exports to Africa declined by 13.5 per cent. USA followed by UAE and Hong Kong were the top export destinations.
- During 2016-17 (April-December) imports declined by 7.4 per cent to US$ 275.4 billion mainly due to decline inPOL imports, Gold and silver and capital goods.
- Top three import destinations of India were China followed by UAE and USA in 2016-17.
- India's trade deficit declined by 23.5 per cent to US$ 76.5 billion in 2016-17 (April-December) as compared to US$ 100.1 billion in the corresponding period of previous year.

Balance of Payments

- India's **Current Account Deficit** (CAD) progressively contracting from US$ 88.2 billion (4.8 per cent of GDP) in 2012-13 to US$ 22.2 billion (1.1 per cent of GDP) in 2015-16. The CAD further narrowed in 2016-17 (H1) to 0.3 per cent of GDP mainly on account of sharp decline in oil import bill and gold imports.
- There is also decline in remittances because of subdued income conditions in source countries, particularly in the gulf region due to downward spiral in oil prices.
- Despite higher net repayments on overseas borrowings and fall in banking capital (net) with building up of foreign currency assets by banks & decline in NRI deposits (net), robust inflow of **foreign direct investment (FDI) and net positive inflow of foreign portfolio investment (FPI)** were sufficient to finance CAD leading to an accretion in foreign exchange reserves in H1 of 2016-17.

External debt

- At end-September 2016, India's external debt stock stood at US$ 484.3 billion, recording a decline of US$ 0.8 billion over the level at end-March 2016, mainly due to a reduction in commercial borrowings and short term external debt.
- The shares of Government (Sovereign) and non-Government debt in the total external debt were 20.1 per cent and 79.9 per cent respectively, at end-September 2016.
- US dollar denominated debt accounted for 55.6 per cent of India's total external debt at end-September 2016, followed by Indian rupee (30.1 per cent), SDR (5.8 per cent), Japanese Yen (4.8 per cent) Pound Sterling (0.7 per cent), Euro (2.4 per cent) and others (0.6 per cent).

Notes

Outlook for the Economy for the year 2017-18

- CSO in its first AE estimated the economy to grow by 7.1 per cent in the current year; however number can be revised downward considering the impact of demonetisation.
- For 2017-18, it is expected that the growth would return to normal i.e. 6¾ per cent to 7½ per cent in 2017-18 as the new currency notes in required quantities come back into circulation and as follow up actions to demonetisation are taken.
- However, the challenges for economy are rising price of crude oil, downward cycle of fixed investment rate, slowdown in global trade and investment flow and hike in fed rate in USA.

Agriculture and Food Management

- Growth rate for the agriculture and allied sectors is estimated to be 4.1 per cent for 2016-17.
- Both production and area sown has increased compared to last year because of good monsoon i.e. 97% rainfall of its long period average (LPA).
- The price policy of Government for major agricultural commodities seeks to ensure remunerative prices to the farmers to encourage higher investment and production, and to safeguard the interest of consumers by making available supplies at reasonable prices.
- To reduce the volatility in pulse prices many measures has been taken on recommendation of a Committee on 'Incentivising Pulses Production Through Minimum Support Price (MSP) and Related Policies' was set up under the Chairmanship of Dr. Arvind Subramanian. These include:

1. Procurement and stock of 2 million tons of pulses stock with targets for individual pulses, especially tur (3.5 lakh tonnes) and urad (2 lakh tonnes).
2. Increase in MSP of pulses, production subsidies for farmers to grow pulses in irrigated areas.
3. Eliminate export ban on pulses and stock limits.
4. Encourage states to delist pulses from their APMCs
5. Create a new institution as a Public Private Partnership (PPP) to compete with and complement existing institutions to procure stock and dispose pulses.
6. Encourage development of GM technologies. Grant expeditious approval to indigenously developed new varieties of pulses.

Industrial, Corporate and Infrastructure Sectors

- As per the first advance estimates of the CSO, growth rate of the industrial sector comprising mining & quarrying, manufacturing, electricity and construction is projected to decline from 7.4 per cent in 2015-16 to 5.2 per cent in 2016-17 due to fall in manufacturing and mining.
- The eight core infrastructure supportive industries, viz. coal, crude oil, natural gas, refinery products, fertilizers, steel, cement and electricity that have a total weight ofnearly 38 per cent in the IIP registered a cumulative growth of 4.9 per cent during April-November, 2016-17 as compared to 2.5 per cent during April-November, 2015-16.
- The Government has liberalized and simplified the foreign direct investment (FDI) policy in sectors like defence, railway infrastructure, construction and pharmaceuticals, etc. Sectors like services sector, construction development, computer software & hardware and telecommunications have attracted highest FDI equity inflows.

Notes

- Many new initiatives have been taken up by the Government to facilitate investment and ease of doing business in the country include such as Make-in-India, Invest India, Start Up India and e-biz Mission Mode Project under the National e-Governance Plan. Measures to facilitate ease of doing business include online application for Industrial License and Industrial Entrepreneur Memorandum through the eBiz website 24x7 for entrepreneurs; simplification of application forms for Industrial Licence and Industrial Entrepreneur Memorandum; limiting documents required for export and import to three by Directorate General of Foreign Trade; and setting up of Investor Facilitation Cell under Invest India to guide, assist and handhold investors during the entire life-cycle of the business.

Services Sector

- As per the first advance estimates of the CSO, growth rate of the services sector is projected to grow at 8.8 per cent in 2016-17. The Commercial service exports also increased and the share of India's commercial services to global services exports increased to 3.3 per cent in 2015. Along with it tourism sector also witnessed a growth of 4.5 per cent in terms of foreign tourist arrivals (FTAs) with 8.2 million arrivals in 2015.

Social Infrastructure, Employment and Human Development

As per the Reserve Bank of India data, expenditure on social services by Centre and States, as a proportion of GDP was 7.0 per cent during 2016-17 (BE), with education and health sectors accounting for 2.9 per cent and 1.4 per cent respectively.

Trends in social sector expenditure

Items	2009-10	2013-14	2014-15	2015-16 RE	2016-17 BE
		As percentage to GDP			
Total Expenditure	28.6	26.6	25.1	28.2	28.4
Expenditure on Social Services	6.9	6.6	5.7	6.9	7.0
of which:					
Education	3.0	3.1	2.6	2.9	2.9
Health	1.4	1.2	1.1	1.3	1.4
Others	2.5	2.3	2.0	2.7	2.7

Source: **Reserve Bank of India.**

A. Employment:

- As per the Annual Employment and Unemployment Surveys (EUS) The Labour Force Participation Rate (LFPR) at the all India level based on usual principal status approach was estimated at 50.3 per cent. The All India LFPR of females is much lower than that for males.

- The North Eastern and Southern States, in general, display high female LFPR as compared to low levels in Northern States. There is a clear shift in employment to secondary and tertiary sectors from the primary sector.

- The growth in employment by category reflects increase in both casual labour and contract workers. This has adverse implications on the level of wages, stability of employment, social security of employees owing to the 'temporary' nature of employment. It also indicates preference by employers away from regular/formal employment to circumvent labour laws.

Notes

- The multiplicity of labour laws and the difficulty in their compliance have been an impediment to the industrial development and employment generation.

B. Education sector:

Low learning outcomes have been a measure challenge in the schools even after improvements in access and retention as per ASER 2014. Some of the underlying causes contributing to low quality of education in the primary sector are teacher absenteeism and the shortage of professionally qualified teachers.

Biometric attendance of teachers, along with regular monitoring by local community and parents could provide solution to it. However, this should be backed by adequate teaching aids, recorded lectures, etc. to fill in for absentee teachers.

C. Health for All:

- India's health policy aims at an integrated approach which will provide accessible, affordable and equitable quality health care to the marginalized and vulnerable sections.
- The aim of good health and well-being for all as envisaged in the Sustainable Development Goal (SDG) 3, "Ensure healthy lives and promote well-being for all at all ages" should be synchronized with India's domestic targets to reap the benefits of the 'demographic dividend.
- Achievements in health sector include

a. Life expectancy has doubled and infant mortality and crude death rates have reduced sharply.

b. India's total fertility rate (TFR) has been steadily declining and was 2.3 (rural 2.5 & urban 1.8) during 2014.

c. Infant Mortality Rate (IMR) has declined to 37 per 1000 live births in 2015 from 44 in 2011. The challenge lies in addressing the huge gap between IMR in rural (41 per 1000 live births) and urban (25 per 1000 live births) areas.

d. The Maternal Mortality Ratio (MMR) declined from 301 maternal deaths per 100,000 live births during 2001-03 to 167 maternal deaths per 100,000 live births during 2011-13. There are wide regional disparities in MMR, with States like Assam, Uttar Pradesh, Rajasthan, Odisha, Madhya Pradesh and Bihar recording MMR well above the all India MMR of 167.

e. The high levels of anaemia prevalent among women in the age group 15-49 have a direct correlation with high levels of MMR. In Haryana and West Bengal more than 60 per cent of women suffer from anaemia. Under the National Health Mission, Government of India has programmes to address the issue of anaemia through health and nutrition education to promote dietary diversification, inclusion of iron foliate rich food as well as food items that promote iron absorption.

Inclusive Policies of the Government

- To have an inclusive society and equal opportunities government has initiated a number of programmes. These include Accessible India Campaign, schemes meant for the economic and social empowerment of people belonging to the minority communities. For social empowerment, the 'Nai roshni' scheme for leadership development of minority women, 'PadhoPradesh', a scheme of interest subsidy on educational loans for overseas studies for the students belonging to the minority communities, etc. are being implemented.
- For skill development and economic empowerment of minorities, schemes like 'Seekho Aur Kamao' (Learn & Earn), Upgrading Skill and Training in Traditional Arts/Crafts for Development (USTTAD)

and 'Nai Manzil'- a scheme to provide education and skill training to the youth from minority communities are in operation.

Climate Change

To combat climate change and unleash actions and investment towards a low carbon, resilient and sustainable future The Paris Agreement entered into force on 4th November 2016.

At 22nd Session of the Conference of Parties (COP 22) to UNFCCC held in Marrakech, Morocco major thrust areas were developing rules and action framework for operationalizing the Paris Agreement and advance work on pre-2020 Actions, Marrakech Action Proclamation for our Climate and Sustainable Development" which captured the sense of urgency to take action on climate change, need to strengthen and support efforts to eradicate poverty, ensure food security and enhance resilience of agriculture and mobilization of USD 100 billion per year as green fund.

India's green actions:

- India ratified the Paris Agreement.
- India's comprehensive NDC target is to lower the emissions intensity of GDP by 33 to 35 per cent by 2030 from 2005 levels, to increase the share of non-fossil fuels based power generation capacity to 40 per cent of installed electric power capacity by 2030, and to create an additional (cumulative) carbon sink of 2.5-3 GtCO2e through additional forest and tree cover by 2030.
- A target of 175 GW of renewable energy capacity to be reached by 2022 In order to achieve the target, the major programmes/ schemes on implementation of Solar Park, Solar Defence Scheme, Solar scheme for Central Public Sector Undertakings, Solar photovoltaic (SPV) power plants on Canal Bank and Canal Tops, Solar Pump, Solar Rooftop, etc. have been launched in recent years.
- India attained 4th position in global wind power installed capacity after China, USA and Germany.
- As on 31st October 2016, India achieved 46.3 GW grid-interactive power capacity; 7.5 GW of grid-connected power generation capacity in renewable energy; and small hydro power capacity of 4.3 GW. In addition, 92305 Solar Pumps were installed and Rs.38,000 crore worth of Green Energy Corridor is being set up to ensure evacuation of renewable energy.
- National Tariff Policy for electricity was amended focus on the environmental aspect with provisions such as

1. Renewable Purchase Obligation in which 8 per cent of electricity consumption excluding hydro power shall come from solar energy by March 2022;
2. Renewable Generation Obligation in which new coal/lignite based thermal plants after specified date to also establish/procure/ purchase renewable capacity;
3. Bundling of renewable power with power from plants whose Power Purchase Agreements have expired or completed their useful life;
4. No inter-state transmission charges for solar and wind power;
5. Procurement of 100 per cent power produced from waste-to energy plants;
6. Ancillary services to support grid operation for expansion of renewable energy, etc.

Apart from it Launch of Solar Alliance, establishment the National Adaptation Fund for Climate Change to assist States and Union Territories to undertake projects and actions for adaptation to climate

Notes

change, imposition of Clean Environment Cess to finance projects under Green Energy Corridor for boosting up the transmission sector, Namami Gange, Green India Mission, Jawaharlal Nehru National Solar Mission, installation of SPV lights and small capacity lights, installation of SPV water pumping systems, SPV Power Plants and Grid Connected Rooftop SPV Power Plants are some major initiatives to fight climate change.

Supplementary Reading

A. Concept of Inclusive Growth

Inclusive growth basically means, "Broad based growth, shared growth, and pro-poor growth". 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 labor force. This definition of inclusive growth implies a direct link between the macro and micro determinants of growth. The micro dimension captures the importance of structural transformation for economic diversification and competition, including creative destruction of jobs and firms.

Processes of inclusion

The three distinct processes of inclusion are: (i) social inclusion, (ii) economic inclusion, and (iii) political inclusion.

i) Social Inclusion

Social inclusion is an overarching framework for addressing various social policy issues, including income inequality, skill levels, education, health inequalities, housing affordability, and work-life balance. Social inclusion promotes more active participation of people living in communities.

ii) Economic Inclusion

The relationship between a productive economy and a society that enjoys high levels of participation, connection and cohesion, and their combined impact on peoples' wellbeing is well appreciated by scholars in recent times. It is their view that an inclusive economy improves the wellbeing of people by directing policy to ensure that there are broad based opportunities to participate in society and the economy.

iii) Political Inclusion

Inclusiveness in the political sphere is vital for social development. A democratic and participatory political organization empowers people to raise their voices against injustices and deprivation. The political inclusion has two main avenues of inclusion: quotas and caste base in political parties.

B. Paris agreement

- The 21st Conference of Parties (COP 21) under the United Nations Framework Convention on Climate Change (UNFCCC) successfully concluded in Paris after intense negotiations by the Parties followed by the adoption of the Paris Agreement on post-2020 actions on climate change. This universal agreement will succeed the Kyoto Protocol.
- Unlike the Kyoto Protocol, it provides a framework for all countries to take action against climate change.
- Placing emphasis on concepts like climate justice and sustainable lifestyles, the Paris Agreement for the first time brings together all nations for a common cause under the UNFCCC.

Notes

- One of the main focus of the agreement is to hold the increase in the global average temperature to well below 2°C above pre- industrial level and on driving efforts to limit it even further to 1.5°C.
- It covers all the crucial areas identified as essential for a comprehensive and balanced agreement, including mitigation, adaptation, loss and damage, finance, technology development and transfer, capacity building and transparency of action and support.
- Salient features of the Paris Agreement:

a) The Paris Agreement acknowledges the development imperatives of developing countries by recognizing their right to development and their efforts to harmonize it with the environment, while protecting the interests of the most vulnerable.

b) The Agreement seeks to enhance the 'implementation of the Convention' while reflecting the principles of equity and CBDR-RC, in the light of different national circumstances.

c) Countries are required to communicate to the UNFCCC climate action plans known as nationally determined contributions (NDCs) every five years. Each Party's successive NDC will represent a progression beyond the Party's then current NDC thereby steadily increasing global effort and ambition in the long term.

d) The Agreement is not mitigation-centric and includes other important elements such as adaptation, loss and damage, finance, technology development and transfer, capacity building and transparency of action and support.

e) Climate action will also be taken forward in the period before 2020. Developed countries are urged to scale up their level of financial support with a complete road map towards achieving the goal of jointly providing US$ 100 billion by 2020. At the same time, a new collective quantified goal based on US$ 100 billion floor will be set before 2025.

f) The Agreement mandates that developed countries provide financial resources to developing countries. Other Parties may also contribute, but on a purely voluntary basis.

g) Developed countries are urged to take the lead in mobilization of climate finance, while noting the significant role of public funds in the mobilization of finance which should represent a progression beyond their previous effort.

h) The Agreement includes a robust transparency framework for both action and support.

i) Starting in 2023, a global stock take covering all elements will take place every five years to assess the collective progress towards achieving the purpose of the Paris Agreement and its long term goals.

j) The Paris Agreement establishes a compliance mechanism, overseen by a committee of experts that operates in a non-punitive way, and is facilitative in nature.

- A marked departure from the past is the Agreement's bottom-up approach, allowing each nation to submit its own national plan for reducing greenhouse gas emissions, rather than trying to repeat a top-down approach advocated by the Kyoto Protocol, giving each country an emission reduction target.

Related Questions:

1. Examine the steps taken by RBI on the recommendations of the Khan Committee to boost investor participation and market liquidity in the corporate bond market.

Notes

2. Though India is seeing declining food inflation, yet the volatility in pulses forced the government to take sustainable steps. In light of it analyse the recommendation of Committee on 'Incentivising Pulses Production through Minimum Support Price (MSP) and Related Policies'.

3. Paris Agreement on Climate change though highlights the cooperation at world levelto combat ill effects of climate change yet Individual country are the unit of its success. In this reference analyse the steps taken by India to combat climate change.

Notes

9 UNIVERSAL BASIC INCOME: A CONVERSATION

Context

A Universal Basic Income (UBI) is a periodic cash payment unconditionally delivered to all on an individual basis. It is not an entitlement but a right by virtue of being a citizen of a country. UBI is a step towards more equal society as it would promote Social equity, reduce poverty directly, and reduce risks related to unemployment, health etc. by providing a safety net. But, In India's context the most important benefit would be in terms of addressing misallocation, exclusion and leakages which grapples plethora of schemes run by government to root out poverty and inequality.

Misallocation is due to administrative incapacity and inefficient delivery. Exclusion is a natural consequence of misallocation and Leakages are due to big and complex delivery system. UBI being delivered universally in bank account would address all the three problems. Added benefits would include increase in financial access due to increased volume of transaction which increases profitability of BC model of delivery. There are concerns that UBI would lead to increase in conspicuous consumption and dropout from labour market but studies have found no evidence in this regard.

However, survey chalks out legitimate concerns. The success of UBI hings on success of JAM and still 1/3rd of adults don't have bank account. The state and Centre need to agree on proportion of funding by each. Finally, taking away all schemes and benefits in lieu of UBI may not be politically feasible. The survey talks about floating the UBI scheme in gradual manner as a way forward.

Technical Terms

A. Characteristics of UBI scheme

A basic income has the five following characteristics:

Periodic: it is paid at regular intervals (for example every month), not as a one-off grant.

Cash payment: Allowing those who receive it to decide what they spend it on. It is not, therefore, paid either in kind (such as food or services) or in vouchers dedicated to a specific use.

Individual: It is paid on an individual basis—and not, for instance, to households.

Universal: It is paid to all, without means test.

Unconditional: It is paid without a requirement to work or to demonstrate willingness-to-work.

B. JAM trinity - An abbreviation for Jan Dhan Yojana, Aadhaar and Mobile number. The government is pinning its hopes on these three modes of identification to deliver direct benefits to India's poor.

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Subsidies cost the exchequer quite a bit. Yet, only a part reaches the poor because of intermediaries, leakages, corruption and inefficiencies. This is where the government hopes that the JAM trinity can help. With Aadhaar helping in direct biometric identification of disadvantaged citizens and Jan Dhan bank accounts and mobile phones allowing direct transfers of funds into their accounts, it may be possible to cut out all the intermediaries.

C. **Randomize control Trials** - In order to test the effect of a variable on a given subject, the subjects are divided into two groups with similar characteristics then the variable is introduced into one group and differences between two groups are studied to know impact of new variable. In UBI case it means taking two similar households and giving UBI to one and observing difference between two groups over a period of time.

D. **How UBI does liberate citizens from paternalistic and clientelistic relationships with the state?**

Clientelism is a political or social system based on the relation of client to patron with the client giving political or financial support to a patron (as in the form of votes) in exchange for some special privilege or benefit. Ex- voting for a party in exchange for future promised freebies. Because UBI would be Universal this incentive would be killed

Paternalism is the interference of a state or an individual with another person, against their will, and defended or motivated by a claim that the person interfered with will be better off or protected from harm. UBI would be in cash so receiver could exercise his discretion to maximize his interests.

Gist of Economic Survey Chapter

Introduction

Despite making remarkable progress in bringing down poverty from about 70 percent at independence to about 22 percent in 2011-12 (Tendulkar Committee), it can safely be said that “wiping every tear from every eye” is about a lot more than being able to imbibe a few calories. It is also about dignity, invulnerability, self-control and freedom, and mental and psychological unburdening. From that perspective, Nehru’s exhortation that “so long as there are tears and suffering, so long our work will not be over” is very much true nearly 70 years after independence.

Idea of a radical option like UBI can be debated to achieve the above objective. UBI requires that every person should have a right to a basic income to cover their needs, just by virtue of being citizens. But there is a need to discuss and debate it pros and cons.

The Conceptual/Philosophical Case for UBI

It has three components: **universality, unconditionality, and agency** (by providing support in the form of cash transfers to respect, not dictate, recipients’ choices) and shows a radical shift in thinking about social justice and productive economy. It is based on idea that:

- Just society needs to guarantee to each individual a minimum income, and
- Which provides the necessary material foundation for a life with access to basic goods and a life of dignity.

It provides various social, economic and administrative benefits to individuals, society and nation.

A. **Social justice**

- It promotes many of the basic values of a society which respects all individuals as free and equal. It promotes liberty because it is anti-paternalistic; it promotes equality by reducing poverty.

Notes

B. Economic benefits

- It promotes efficiency by reducing waste in government transfers.
- System it may simply be the fastest way of reducing poverty.
- UBI is also, paradoxically, more feasible in a country like India, where it can be pegged at relatively low levels of income but still yield immense welfare gains.
- They allow for more non-exploitative bargaining in labour market

C. Administrative benefits

- A UBI is also practically useful. The circumstances that keep individuals trapped in poverty are varied; the risks they face and the shocks they face also vary. The state is not in the best position to determine which risks should be mitigated and how priorities are to be set and UBI restores decision making with citizens.
- By taking the individual and not the household as the unit of beneficiary, UBI can also enhance agency, especially of women within households.
- In India the case for UBI has been enhanced because of the weakness of existing welfare schemes which are riddled with misallocation, leakages and exclusion of the poor.

However, it is important to recognize that universal basic income will not diminish the need to build state capacity: the state will still have to enhance its capacities to provide a whole range of public goods. UBI is not a substitute for state capacity: it is a way of ensuring that state welfare transfers are more efficient so that the state can concentrate on other public goods.

The Conceptual Case Against UBI

From an economic point of view there are three principal and related objections to a universal basic income.

A. **The first is whether UBI reduces the incentive to work**, which is highly exaggerated because the levels at which universal basic income are likely to be pegged are going to be minimal guarantees at best;

B. **The second concern** is, **should income be detached from employment**? But that is already done India in form of rich and privileged accepting non-work related income inherited from their parents. So, receiving a small unearned income as it were, from the state should be economically and morally less problematic than the panoply of "unearned" income our societies allow.

C. **The third is a concern out of reciprocity**. Should income be unconditional, with no regard to people's contribution to society? Answer to this is that individuals do contribute to society. UBI in fact will recognize non-wage work by individuals like housewife.

D. Temptation Goods: Would A UBI Promote Vice?

- Detractors of UBI argue that, as a cash transfer programme, this policy will promote conspicuous spending or spending on social evils or temptation goods such as alcohol, tobacco etc.
- But NSSO 2011-12 data shows that these goods form a smaller share of overall budget/ consumption as overall consumption increases. This provides an indication that an increase in income from UBI alone will not necessarily lead to an increase in temptation goods consumption.

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E. Moral Hazard: Would A UBI reduce Labour Supply?

- It is argued that free money makes people lazy and they drop out of the labour market because their income levels have increased.
- However controlled trials of government cash transfer programs in 6 developing countries {Honduras, Morocco, Mexico, Philippines, Indonesia and Nicaragua where cash transfer formed between 4 percent (Honduras) and 20 percent (Morocco) of household consumption.} find no significant reduction in labour supply (inside and outside the household) for men or women from the provision of cash transfers. Similar results were obtained from trials in Indian villages from state of Madhya Pradesh.

F. Another important question why universal basic income and why not targeted direct transfers.

Arguments in Favour and Against UBI

Favor	Against
Poverty and vulnerability reduction Poverty and vulnerability will be reduced in one fell swoop.	**Conspicuous spending** Households, especially male members, may spend this additional income on wasteful activities.
Choice A UBI treats beneficiaries as agents and entrusts citizens with the responsibility of using welfare spending as they see best; this may not be the case with in-kind transfers.	**Moral hazard (reduction in labour supply)** A minimum guaranteed income might make people lazy and opt out of the labour market.
Better targeting of poor As all individuals are targeted, exclusion error (poor being left out) is zero though inclusion error (rich gaining access to the scheme) is 60 percent[5].	**Gender disparity induced by cash** Gender norms may regulate the sharing of UBI within a household – men are likely to exercise control over spending of the UBI. This may not always be the case with other in-kind transfers.
Insurance against shocks This income floor will provide a safety net against health, income and other shocks.	**Implementation** Given the current status of financial access among the poor, a UBI may put too much stress on the banking system.
Improvement in financial inclusion Payment – transfers will encourage greater usage of bank accounts, leading to higher profits for banking correspondents (BC) and an endogenous improvement in financial inclusion. Credit – increased income will release the constraints on access to credit for those with low income levels.	**Fiscal cost given political economy of exit** Once introduced, it may become difficult for the government to wind up a UBI in case of failure.
Psychological benefits A guaranteed income will reduce the pressures of finding a basic living on a daily basis.	**Political economy of universality – ideas for self-exclusion** Opposition may arise from the provision of the transfer to rich individuals as it might seem to
Administrative efficiency A UBI in place of a plethora of separate government schemes will reduce the administrative burden on the state.	**Exposure to market risks (cash vs. food)** Unlike food subsidies that are not subject to fluctuating market prices, a cash transfer's purchasing power may severely be curtailed by market fluctuations.

Counter arguments in favor of UBI

Despite all these arguments against UBI, there are various reasons which favor consideration of the idea of universalisation of the schemes, like:

Universalization prevents misallocation and diversion of resources. This can be more understood by analyzing the problems with present welfare schemes.

Large number of schemes:

- India has large number of social welfare schemes. The Budget for 2016-17 indicates that there are about 950 central sector and centrally sponsored sub-schemes in India accounting for about 5 percent of the GDP by budget allocation. Considerable gains could be achieved in terms of bureaucratic costs and time by replacing many of these schemes with a UBI.

Misallocation of resources across districts:

- The poorest areas of the country often obtain a lower share of government resources when compared to their richer counterparts. Under no scheme the poorest districts which have 40% of poor receive 40 percent of the total resources – in fact, for the MDM and SBM, the share is under 25 percent.
- **This misallocation results into errors or inclusion of wrong persons and exclusion of genuine poor**. An estimate of the exclusion error from 2011-12 suggests that 40 percent of the bottom 40 percent of the population are excluded from the PDS

UBI cannot only help in overcoming these above mentioned issues, but will provide other benefits.

Brief history of targeting in India

India's experience with targeted delivery of welfare programs has not been much encouraging. Targeted delivery started in 1992 based on self-reporting income criteria to identify the poor. Later in 1997 and 2002 multidimensional criteria was used to identify poor. However, all these were not able to remove the issues of manipulation and corruption, with the crowding out of the poor and the truly deserving from BPL card ownership and leakages to the rich.

Targeting was both inefficient and inequitable, a license to fraud that spawned an entire ecosystem of middlemen and petty abuse. All this forced governments to look for alternatives like SECC (Socio Economic Caste Census), which used automatic exclusion criteria to identify poor. Under Food Security Act the coverage was enhanced to nearly 70% choosing to exclude easily identifiable well off. All these indicate gradual move by governments towards universalization.

A. Improvement in Governance

- Misallocation to districts with less poor will be tackled because resources will be directly transferred to beneficiaries without involving bureaucratic hassles which result into misallocation.
- It will also reduce exclusion errors. Because it is by design universal.
- It will also reduce out of system leakages because JAM platform will be used to directly transfer benefits to beneficiary accounts.

B. Insurance against risk

It is found that slightly more than 50 percent of rural households across India face idiosyncratic (individual specific) shocks like bad health, job loss and aggregate shock like natural disaster and natural shock and make them vulnerable to poverty. UBI can prevent such poverty trap.

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C. Psychological benefit

The World Development Report argues that individuals living in poverty have

a) A preoccupation with daily hassles and this results in a depletion of cognitive resources required for important decisions;

b) Low self-image that tends to blunt aspirations;

An assured income could relieve mental space that was used to meet basic daily consumption needs to be used for other activities such as skill acquisition, search for better jobs, etc,and will improve psychological wellbeing.

D. Improved financial inclusion

Financial inclusion in India has progressed well under PMJDY, with ownership of bank accounts increasing to 2/3rd of adults and active usage to 40%, with only states like Bihar, UP, Jharkhand being laggard. However effective financial inclusion, in terms of active usage is constrained by two factors:

- **Physical distance separating people from these bank branches**: which is around 4.5 Km from any form of access point (ATM, BC, Bank etc)
- Number of persons per bank, which are very high in high population density like UP, Bihar etc. and greater burden on banks.

UBI can help in improving both these situations.

- UBI will help increasing financial inclusion by increasing bank transactions, increasing business per BC, reducing per unit fixed cost for BCs and thus increasing their numbers.
- At 90% financial inclusion rate with UBI of INR 12,000/person/year and 1% commission for BCs can reduce average distance from banking access point from 4.5Km to 2.5 Km and dramatically improving financial inclusion.

E. Access to formal credit

Absence of assured income is a constraint for accessing formal credit. UBI can help in overcoming it. Debt and Investment Survey (2013) shows that

- As one moves along the consumption spectrum, the proportion of farmers taking informal loans falls and formal loans take over.
- That there is sudden increase in median loan amounts from zero to sudden increase at 78th percentile (INR 90,000/household/year).

It shows that if everybody's consumptions could be increased to this level, there might be significant jump in access to formal credit. It also shows that as UBI amount increases more number of households will have access to formal credit, as more number of households will cross 78th percentile limit.

However, it may also occur that income threshold of 78th percentile group an increase and dampening the effect of UBI on releasing credit constraints.

A way forward depending upon the potential costs, fiscal space with governments can be analyzed and possibilities found out.

Notes

What would be the potential cost of UBI?

The cost of UBI on government finances will depend upon the targets chosen and number of assumption. Based on 2011-12 poverty distribution and their consumption expenditure if a target poverty level of 0.45% is chosen, with UBI of INR 7620 per year (it corresponds to the annual consumption of marginal poor, who is at 0.45% threshold) and 75% coverage the financial cost of UBI will be 4.9% of GDP.

Fiscal space to Finance a UBI

If we look at the present government welfare programs which are shown in fig., we find that:

- Subsidies for the non-poor/middle class households, equivalent to about 1 percent of GDP.

Fiscal Cost of Existing Central Government Programmes (2015-16)

Implicit Middle Class "Subsidies"[29] (percent of GDP)[30]	Total
LPG	0.21
Railways-1 (only A/C)	0.01
Railways-2 (Sleeper Class)	0.07
Aviation turbine fuel	0.01
Fertilizer (Urea)	0.04
Personal Income-tax Exemptions	0.44
Interest Subvention Scheme for farmers	0.1
Mudra (Interest Subsidy)	0.11
Gold	0.08
SUB-TOTAL	1.05

The middle class subsidies equal to the cost of a UBI of INR 3240 per capita per year provided to all females. This will cost a little over 1 percent of the GDP – or, a little more than the cost of all the middle-class subsidies.

However, taking away subsidies to the middle-class is politically difficult for any government. It is clear that while the fiscal space exists to start a de facto UBI, political and administrative considerations make it difficult to do this without a clearer understanding of its larger economy-wide implications.

Guiding Principle for Setting up a UBI

A. De jure universality, de facto quasi-universality

Using automatic exclusion criterion like:

- Ownership of key assets such as AC, automobiles
- Adopt a give up scheme
- Public display of UBI list, this would 'name and shame' the rich who choose to avail themselves of UBI.
- Self-targeting: under this Develop a system where beneficiaries regularly verify them in order to avail themselves of their UBI – the assumption here is that the rich, whose opportunity cost of time is higher, would not find it worth their while to go through this process and the poor would self-target into the scheme. However, this run counters to the objective of JAM trinity.

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B. Gradualism

A guiding principle is gradualism: the UBI must be embraced in a deliberate, phased manner. A key advantage of phasing would be that it allows reform to occur incrementally – weighing the costs and benefits at every step. This can be done in following ways:

C. Choice to persuade and to establish the principle of replacement, not additionally

- Under this UBI is offered as a choice to beneficiaries of existing programs. Apart from having the normal advantages of cost reduction, giving choice to beneficiaries it will give them greater negotiating power with administrators, which will force latter to improve their performance.
- However it will have its own disadvantages of enforcing current problems with targeting, continues with the problem of misallocation with richer districts getting more, does not solve the problem of wrong exclusion and inclusion and will be cumbersome to administer.

D. UBI for women

- It is worth considering because women suffer worse prospects in almost every aspect of their daily lives – employment opportunities, education, health or financial inclusion. Simultaneously, the higher social benefits and the multi-generational impact of improved development outcomes for women.
- A UBI for women can, therefore, not only reduce the fiscal cost of providing a UBI (to about half) but have large multiplier effects on the household. It will increase their bargaining power; reduce concerns of money being splurged on conspicuous goods and by factoring in children in household higher UBI can be provided to women.

However this has three problems of counting number of children, parents may go for more children and identification & phasing out of boys after they reach 18 years of age.

E. Universalize across groups:

Certain groups like widows, old age, divyang etc can be included under UBI net under phase-1 because these groups are easily identifiable. However this may suffer from less access to bank accounts and not part of JAM trinity.

F. UBI in urban areas:

Urban areas have proper banking infrastructure and as poor are less dependent on state for sustenance, a disruptive step like UBI will not be that tricky in these areas.

Prerequisites for UBI

A. JAM

Financial inclusion is very necessary for success of UBI. In India considerable ground has been covered for JAM preparedness but still a lot needs to be done.

- 1/3 of population is still without bank account and most of them belong to vulnerable social groups like SC, ST, disabled etc.
- Though 26.5 cr. Jan Dhan accounts have been opened, but linkages with Aadhar lags in J&K and north east states.

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- Though 1 billion Aadhar cards have issued, but there are instances of authentication failure in states like Jharkhand (49% failure rates) and Rajasthan (having 37% failure rates), which results into exclusion.

It is not clear, whether UBI will certainly result into fewer leakages. Given the amount of cash that will flow through the system under the UBI and the fungible nature of money, one could imagine a perverse equilibrium where the UBI results in greater capture by corrupt actors.

This, once again, reiterates the role of a transparent and safe financial architecture that is accessible to all – the success of the UBI hinges on the success of JAM.

B. Center-state negotiations

UBI amount, sharing between center and state will be very crucial for success of UBI. All these will require complex negotiations between federal stakeholders.

Initially, a minimum UBI can be funded wholly by the center. The center can then adopt a matching grant system wherein for every rupee spent in providing a UBI by the state, the center matches it.

Conclusion

UBI is a powerful idea whose time even if not ripe for implementation is ripe for serious discussion. UBI can help in wiping tears form all eyes, which Mahatma Gandhi dreamed of, but it would also have serious consequences in form of

- Uncompensated reward harming responsibility and effort;
- Effect on macro-economic stability of country; and
- Recognizing exit problem in India, UBI may become another add-on government programme,which would have come to mind of Mahatma Gandhi.

Supplementary Reading

Left-wing views - Socialist and left-wing economists and sociologists have advocated a form of Universal Basic Income (UBI) as a means for distributing the economic profits of publicly owned enterprises to benefit the entire population (also referred to as a social dividend), where the basic income payment represents the return to each citizen on the capital owned by society. Basic income as a project for reforming capitalism into a socialist system by empowering labor in relation to capital, granting labor greater bargaining power with employers in labor markets, which can gradually de-commodify labor by decoupling work from income. Some thinkers view an income guarantee would benefit all workers by liberating them from the anxiety that results from the "tyranny of wage slavery" and provide opportunities for people to pursue different occupations and develop untapped potentials for creativity.

Right Wing View - For thinkers on the right, the UBI. seems like a simpler, and more libertarian, alternative to the thicket of anti-poverty and social-welfare programs. For their part, right-wing advocates of the UBI view it as a streamlined replacement for complicated welfare payments. For this reason, Milton Friedman, an economist known for his laissez-faire beliefs, wanted to replace all welfare with a simpler system that combined a guaranteed minimum income.

Debate in Europe - European Parliament's committee on Legal affairs (JURI) adopted a report on "Civil law rules on robotics" which considers the legal and economic consequences of the rise of robots and artificial intelligence devices. The report argues that development of robotics and AI may result in a large

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part of the work now done by humans being taken over by robots, so raising concerns about the future of employment and the viability of social security systems, creating the potential for increased inequality in the distribution of wealth and influence. To cope with those consequences, the report makes a strong call for basic income.

On the other hand, in June 2016, Swiss voters overwhelmingly rejected a proposal to guarantee an income to Switzerland's residents, whether or not they are employed, an idea that has also been raised in other countries amid an intensifying debate over wealth disparities and dwindling employment opportunities.

Switzerland was the first country to vote on such a universal basic income plan, but other countries and cities either have been considering the idea or have started trial programs. Finland has introduce a pilot program for a random sample of about 10,000 adults who will each receive a monthly handout of 550 euros, about $625. The intent is to turn the two-year trial into a national plan if it proves successful.

Views from Experts : The Indian Statistical Institute hosted its 12th Annual Conference on Economic Growth and Development (ACEGD) on December 19-21, 2016. ACEGD's plenary sessions included a 90-minute panel on universal basic income and its relevance for India.

This conference included a panel on UBI, featuring five economists: Debraj Ray (New York University), Kalle (Karl Ove) Moene (University of Oslo), Rajiv Sethi (Columbia University), Himanshu (Jawaharlal Nehru University), and Amarjeet Sinha (Government of Bihar).

Ray and Moene have jointly developed a proposal for what they call a "universal basic share" (UBS) in India. Like a UBI, a UBS would provide each citizen with regular unconditional cash transfers of an equal amount. However, in contrast to most UBI proposals, a UBS fixes the amount of these transfers to a fraction of the GDP rather than a specific monetary amount. Ray and Moene recommend that India dedicate 12% of its GDP to the provision of a UBS. They calculate that, at present, this would provide each adult citizen with a basic income approximately equal to the country's poverty line.

The last two panelists, **Himanshu and Sinha**, argue that India should prioritize public spending on universal basic services, rather than simply distributing cash to individuals. About UBI, Himanshu states that the question is not whether it should be adopted, but why and when. While allowing that UBI is a good idea in principle, he maintains that it is not yet time to introduce such a policy in India, given that many in the country lack clean water, access to education, and other essential public goods. Sinha, expanding on Himanshu's thesis, stresses that "we should not lose sight of the need to craft credible public systems" — and worries that a UBI would divert money and attention from necessary improvements of education, health, housing, and public infrastructure.

Relevant Questions

1. What do you understand by UBI? Is implementation of UBI is feasible for a developing country like India? What probable strategies can be adopted for implementing UBI?
2. Has targeted programs been able to deliver desired results in India? If not, then what changes should be implemented to ensure efficient delivery through various welfareprograms?
3. Critically analyze, whether introduction of UBI, be considered as culmination of continuous subsidy reforms that are being implemented for past 15 years?
4. "Despite improvement in delivery of targeted schemes in past decade, there is a case for UBI". Comment
5. What could be possible hindrances in implementing UBI? Can it be implemented universally in India? If not, then what could be some practical solutions?

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10 INCOME, HEALTH, AND FERTILITY: CONVERGENCE PUZZLES

Context

Despite rapid overall growth, there is striking evidence of divergence, or widening gaps in income and consumption across the Indian states, in sharp contrast to patterns within China and across the world. This trend is particularly puzzling since that the forces of equalization-trade in goods and movement of people-are stronger within India than they are across countries, and they are getting stronger over time. Compared to international standards and accounting for levels of income, India does well on life expectancy, not-so-well on infant mortality rate, and strikingly well on fertility rate.

Hence in this Chapter there is analysis of India`s growth and development in the parameters of Income, Health, and Fertility. Also it presents how all these parameters show convergence as well as divergence compared to other countries of the world. Especially it focuses on China and India in many instances.

Technical Terms

A. **Gross State Domestic Product (GSDP)** is defined as a measure, in monetary terms, of the volume of all goods and services produced within the boundaries of the State during a given period of time, accounted without duplication.

B. **Life expectancy at birth (LE)** indicates the number of years a newborn would live if prevailing patterns of mortality at the time of its birth were to stay the same throughout its life.

C. **Infant mortality rate (IMR)** is defined as the number of infants dying before reaching one year of age, per 1,000 live births in a given year.

D. **Total fertility rate (TFR)** is defined as the number of children that would be born to a woman if she were to live to the end of her childbearing years and bear children in accordance with age-specific fertility rates in a given year.

E. **Convergence** means that a state that starts off at low performance levels on an outcome of importance, say the level of income or consumption, should see faster growth on that outcome over time, improving its performance so that it catches up with states which had better starting points.

Gist of Economic Survey Chapter

Despite rapid overall growth, there is striking evidence of divergence, or widening gapsin income and consumption across the Indian states, in sharp contrast to patterns within China and across the world. This trend is particularly puzzling since that the forcesof equalization-trade in goods and movement of people-are stronger within Indiathan they are across countries, and they are getting stronger over time. This raises thepossibility that governance traps are

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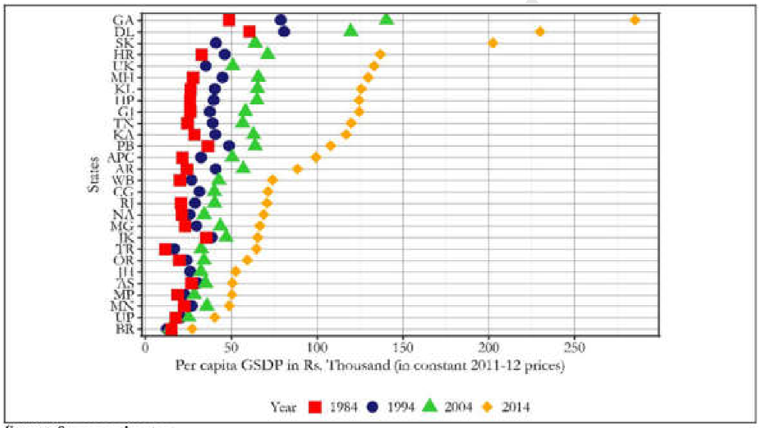
impeding equalization within India. In contrast,health outcomes are converging within India. Compared to international standards and accounting for levels of income, India does well on life expectancy, not-so-well on infantmortality rate, and strikingly well on fertility rate.

India's economic performance has been remarkablein the aggregate. Its continued success as a federation depends on the progress of each ofits individual states. What can be a reasonable standard for assessing how well the states are doing? One intuitive metric can be to see how well individual states have done over time ontwo broad sets of indicators: economic and health/demographic indicators. This analysis starts from the 1980s because it allows for a longer term perspective; but also because that is the time when the structural break from theprevious era of the "Hindu Growth Rate"(to use the late Professor Raj Krishna's term).

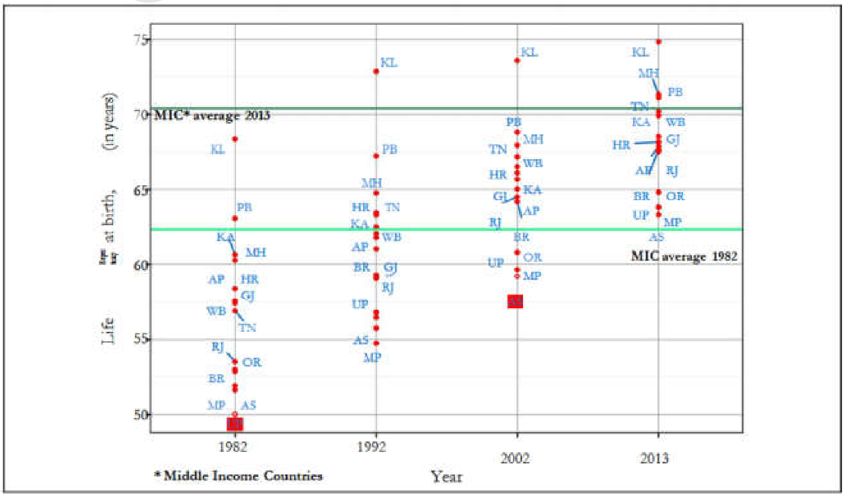
Income Levels over the years in India, All Indian States



Source: Survey estimates

Plots the level of real per capitaGSDP over time between 1983 and 2014(the latest year for which comprehensive datais available). It is clear that, especially duringthe last decade, there has been an across-theboard improvement reflected in the wholedistribution shifting right. For example,between 1984 and 2014, the least developedstate (Tripura) increased its per capita GSDP5.6 fold; (from per capita GSDP of Rs.11,537 in 1984 to Rs. 64,712 in 2014) and themedian state (Himachal Pradesh) increasedits income level 4.3 fold.

Life Expectancy Levels Over Time in India



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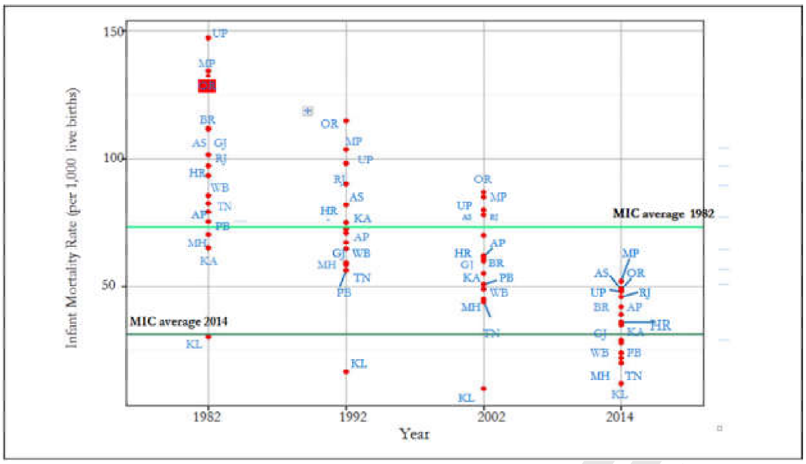
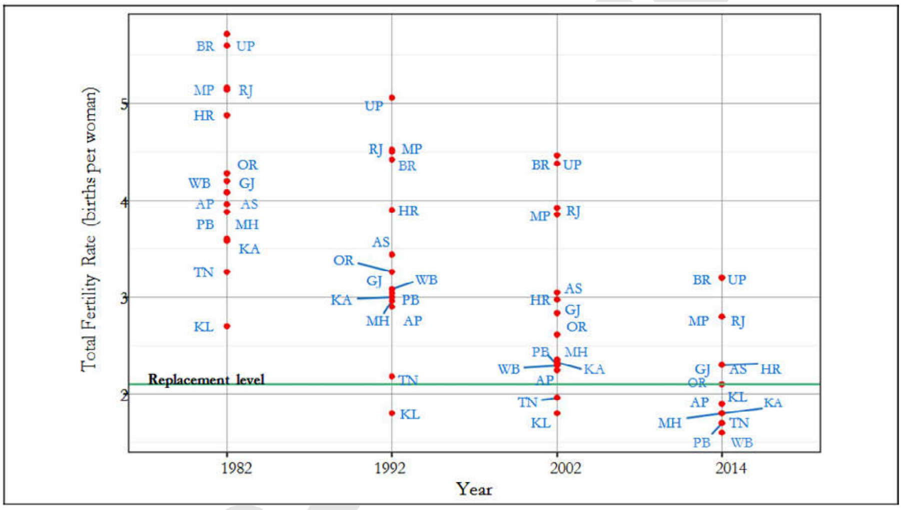
Infant Mortality Rate (IMR) Levels Over Time in India



Total Fertility Rate (TFR) Levels Over Time in India



Figures 2A, 2B and 2C show plotsfor life expectancy, infant mortality rate,and total fertility rate for Indian states. Life Expectancy at birth (LE) indicates the numberof years a new-born would live if prevailingpatterns of mortality at the time of its birthwere to stay the same throughout its life.

IInfant mortality rate (IMR) is defined as the number of infants dying before reaching one year of age, per 1,000 live births in a given year. Total fertility rate (TFR) is defined as the number of children that would be born to a woman if she were to live to the end of her child bearing years and bear children in accordance with age-specific fertility rates in a given year.

Across these health and demographic indicators, there have been dramatic improvements: Over the last 3 decades, the poorest performer (UP) has increased its life expectancy by 13.8 years, reduced its IMRby 99 points, and lowered its TFR by 2.5 points (with a level of 3.2 TFR in 2014).

The corresponding numbers for the median state are: A rise in life expectancy by 12.5 years (West Bengal), a fall in IMR by 36 points (Karnataka), and a drop in TFR by 1.8 points (Assam).

While these developments are encouraging, they don't allow a full assessment because there is no obvious benchmark to measure these improvements. How has Odisha done relative to Kerala? How haveOdisha and Kerala done relative to otherstates? Economic theory provides one metricto make such comparisons: convergence (orunconditional convergence).

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Convergence means that a state thatstarts off at low performance levels on an outcome of importance; say the level of income or consumption, should see faster growth on that outcome over time, improving its performance so that it catches up with states which had better starting points. For example, since the per capita GSDP of Odisha in 1984 was 25 percent lower than the per capita GSDP of Kerala, traditional convergence theory would suggest that Odisha would experience higher growth rates over time, thereby reducing the gap between the two states.

Convergence is thus an intuitive measureof absolute and relative performance, allowing national and international comparisons. It measures the rate of catch-up, in particular whether less developed states have caught up with richer ones and hence whether regional dispersion is increasing.

The relationship is strongly negative for the world and China, and weakly positive for India.Poorer countries are catching up with richer countries, the poorer Chinese provinces are catching up with the richer ones, but in India,the less developed states are not catching up; instead they are, on average, falling behind the richer states.

Internationally, growth rates of per capita GDP widened at least since the 1820s with poorer countries growing slower than richer countries, leading to the basic divide between advanced and developing countries. However, since 1980 this long term trend was reversed and poorer countries started catching up with richer ones. In stark contrast, there continues to be divergence within India or an aggravation of regional inequality.

The opposing results in India versus those in China and internationally poses a deep puzzle. Convergence happens essentially through trade and through mobility of factors of production. If a state/country is poor, the returns to capital must be high and should be able to attract capital and labour,thereby raising its productivity and enabling catch up with richer states/countries. Trade,based on comparative advantage, is really a surrogate for the movement of underlying factors of production as Samuelson pointed out early on. A less developed country that has abundant labour and scarce capital will export labour-intensive goods (a surrogate for exporting unskilled labour) and imports capital-intensive goods (a surrogate for attracting capital).

The main finding suggests that India stands out as an exception.Within India, where borders are porous,convergence has failed whereas in China,we observe successful convergence. Even across countries where borders are much thicker (because of restrictions on trade, capital and labour) the convergence dynamic has occurred. The driving force behind the Chinese convergence dynamic has been the migration of people from farms in the interior to factories on the coast, raising productivity and wages in the poorer regions faster than in richer regions.

The Indian puzzle is deeper still because it can be seen that, contrary to perception, trade within India is quite high. Although further research is requiredto understand the underlying reasons, one possible hypothesis is that convergence failsto occur due to governance or institutional traps. If that is the case, capital will not ûow to regions of high productivity because this high productivity may be more notional than real. Poor governance could make the risk-adjusted returns on capital low even in capital scarce states. Moreover, greater labour mobility or exodus from these areas, especially of the higher skilled, could worsen governance.

A second hypothesis relates to India's pattern of development. India,unlike most growth successes in Asia, has relied on growth of skill-intensive sectors rather than low-skill ones (reûected not just in the dominance of services over manufacturing but also in the patterns of specialization within manufacturing). Thus,if the binding constraint on growth is the availability of skills, there is no reason why labour productivity would necessarily be high in capital scarce states. Unless the less developed regions are able to generate skills, (in addition to providing good governance) convergence may not occur.

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Both these hypotheses are ultimately not satisfying because they only raise an even deeper political economy puzzle. Given the dynamic of competition between states where successful states serve both as models (examples that become evident widely) and magnets (attracting capital, talent, and people),why isn't there pressure on the less developed states to reform their governance in ways that would be competitively attractive? Inother words, persistent divergence amongst the states runs up against the dynamic of competitive federalism which impels, or atleast should impel, convergence.

In contrast, on health and demography,there is strong evidence of convergence amongst the states in the 2000s. This was not true in the previous decades for IMR and fertility. Here it is the international contrast is striking. With regards to life expectancy, the Indian states are close to where they should be given their level of income. However, this is not true of IMR,suggesting that the "mother and child" bear the brunt of weaker delivery of health services.What really stand out in the international comparison are fertility and how much better the Indian states are performing than their international counterparts on that metric.These unusually large declines in fertility have strong—and positive—implications for India's demographic dividend going forward.

Supplementary Readings

A. Indian States By GDP Per Capita

Goa has highest NSDP per capita among 33 Indian states and union territories. NSDP per capita of Goa is estimated at 224,138 Indian rupees in 2013-14 at current prices. Ranking of Delhi is two with per capita income around of 212,219 INR. Sikkim is at third, Chandigarh is at forth and Puducherry is fifth richest economy of India.

Bihar, Uttar Pradesh, Manipur, Assam, and Jharkhand is top 5 poorest state in terms of nsdp per capita. These five states have net state domestic product per capita below Rs. 50,000.

Per capita income of Goa is 3.01 times more than India's average and 7.18 times more than poorest state Bihar. GDP per capita of Bihar is 31,199 INR for year 2013-14 and 36,143 for 2014-15.

B. Per Capita Income For States

Top Ranked States (Decreasing Order)

Rank	State	NSDP capita (INR at Current prices)		$ (2014)
		14-15	13-14	
1	Goa	-	224,138	4,903
2	Delhi	240849	212,219	4,642
3	Sikkim	-	176,491	3,861
4	Chandigarh	-	156,951	3,433
5	Puducherry	175006	143,677	3,143
6	Haryana	147076	133,427	2,919
7	Maharashtra	129235	117,091	2,561
8	Tamil Nadu	128366	112,664	2,464
9	A. & N. Islands	-	107,418	2,350
10	Gujarat	-	106,831	2,337

Least Ranked States (Decreasing Order)

Notes

26	Chhattisgarh	64442	58,547	1,281	29047	28,373
27	Odisha	59229	52,559	1,150	26531	24,929
28	Madhya Pradesh	59770	51,798	1,133	29218	26,853
29	Jharkhand	52147	46,131	1,009	30950	28,882
30	Assam	49480	44,263	968	23968	23,392
31	Manipur	-	41,573	909	-	24,042
32	Uttar Pradesh	40373	36,250	793	20057	19,233
33	Bihar	36143	31,199	682	16801	15,506
	India		74,380	1,627		39,904

C. India and the MDGs Related to IMR, MMR

Goal 4: Reduce Child Mortality

The fourth Millennium Development Goal aims to reduce mortality among children under five by two-thirds. India's Under Five Mortality (U5MR) declined from 125 per 1,000 live births in 1990 to 49 per 1,000 live births in 2013. The MDG target is of 42 per 1000, which suggests that India is moderately on track, largely due to the sharp decline in recent years.

Children Matter

- More than one third of the population is below 18 years. We have the largest young population in the world. This is not a "demographic dividend" if millions of young people lack access to health and education and are prevented from becoming useful members of society. It can become a "demographic trap" if each new generation fails to space and limit family size.
- 38% births are not registered which impacts adversely on planning as well as nationality.
- Two thirds of deaths occur in the first week of life and two thirds of them in the 2 days of life. Almost 45% of neonatal deaths take place within 48 hours of birth.
- The declining number of girls in the 0-6 age group is a cause for alarm. For every 1000 boys there are only 927 females - even 798 in Punjab & 819 in Haryana.

Goal 5: Improve Maternal Health

From a Maternal Mortality Rate (MMR) of 437 per 100,000 live births in 1990-91, India is required to reduce MMR to 109 per 100,000 live births by 2015. Between 1990 and 2006, there has been some improvement in the Maternal Mortality Rate (MMR), which has declined to 167 per 100,000 live births in 2009. However, despite this, India's progress on this goal has been slow and off track.

Causes of High Maternal Mortality

- Around 30% of all women need emergency care during delivery.
- Only 35% of all deliveries are conducted by a doctor.
- Only 15% are conducted by a nurse, ANM, midwife or Lady Health Visitor.
- In urban areas more than 69% of the deliveries took place in institutions but in rural areas only 30% took place in institutions. (DLHS2)

Notes

Maternal Health affects infant health

- A child's nutritional status begins with a woman's nutritional status during adolescence and pregnancy.
- The risk of a woman dying from a complication related to pregnancy or childbirth Developed Countries - 1 in 2800 India - 1 in 100
- Many of the surviving mothers suffer from serious disease, or physical disability caused by complications during pregnancy or childbirth.

D. HDI Rank Of India And Parameters Comparison With World (Data Refer To 2014)

HDI rank: 130 out of 188 .

Human Development Index (HDI) Value : 0.609 and World : 0.711.

Life expectancy at birth (years) :68 and World : 71.5.

Gross national income (GNI) per capita(2011 PPP $) :5,497 and World : 14,301.

E. Total Fertility Rate Data

In India the Total Fertility Rate is **2.4.**

Among the bigger States, Tamilnadu and West Bengal has the lowest TFR of 1.7 and the highest TFR recorded is 3.6 for Bihar.

TFR is considered to be a useful indicator for analysing the prospects for population stabilization.

Highest and Lowest Total Fertility Rates, 2016

As per2016 Population Reference Bureau

HIGHEST

1. Niger 7.6
2. South Sudan 6.7
3. Congo, Dem. Rep. 6.5
4. Chad 6.4
5. Somalia 6.4

LOWEST

1. Korea, South 1.2
2. Romania 1.2
3. Singapore 1.2
4. Taiwan 1.2
5. Bosnia-Herzegovina 1.3
6. Greece 1.3

Notes

Analysis of TFR , IMR and MMR and Relationship with Population and Health Profile of India

India accounts for 2.4% of the world's surface area yet it supports 16.7% of the world's population. As the population grows, the pressure on natural resources will intensify. Population pressure will reduce the per capita availability of land for farming, which will affect availability of food grain, drinking water, besides excluding millions of people from the benefits of health and education and the opportunity to become productive members of society. More than half a billion Indians are less than 25 years of age.

In the states where the growth rates are high, maternal mortality and infant mortality is also very high. Repeated child births aggravate the health and survival risks to both mother and child. According to the International Institute for Population Sciences, 2006 in a study prepared for the Ministry of Health and Family Welfare and National Commission on Population, early pregnancies before the age of 20 increase maternal and child birth risks.

The societal pressure for early child bearing and lack of spacing thereafter affects the mother's health and can lead to death of the infant or the birth of an underweight child. This sets in motion a vicious cycle of births, deaths and ill-health. It affects overall development. It is vitally necessary to make family planning services available where men and women can access them freely. IIPS's study indicates that in many states like Bihar, Jharkhand, Rajasthan, Uttar Pradesh and some North Eastern States several districts have a low couple protection rate of 40%. This is in contrast to the rest of the country where the couple protection rates are 52 to 62%. Unless young people adopt family planning methods and space families, population growth will pull back the development of the country.

Related Questions

1. Identify the major factors that contribute to the growing regional inequality in India? Also suggest measures to address this issue?
2. Though health and education spending in India is too low, yet the regional inequalities have reduced in these areas; this identifies that there is robust private spending on them. Critically analyze.
3. Compare the present status of IMR and MMR in India's goal to achieve Sustainable Development Goals. Assess India's Position on achievement of similar goals in MDGs?
4. Analyze the growth of India's National Income in recent decade. How far per capita income growth can affect to reduce MMR and IMR. Discuss critically.
5. Do Indian States fare well in Stabilizing Population? Discuss the Achievements of states in reducing TFR and present strategies for the same.
6. Development as a concept has variable parameters. Discuss strategies to compare the growth of Indian States which started on different levels of Growth and development parameters. Suggest measures to compare the performance of States using Equalizing methods?

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11 ONE ECONOMIC INDIA: FOR GOODS AND IN THE EYES OF THE CONSTITUTION

Context

The popular impression is one of an India having achieved political integration but an incommensurate economic integration. Based on a novel source of Big Data-invoice level transactions from the Goods and Services Tax Network (GSTN)-the chapter documents high levels of internal trade in goods. India's internal trade-GDP ratio at about 54 per cent is comparable to that in other large countries.

There is enormous variation across states in their internal trade patterns. Smaller states tend to trade more, while the manufacturing states of Tamil Nadu, Maharashtra and Gujarat tend to have trade surpluses (exporting more than importing). Belying their status as agricultural and/or less developed, Haryana and Uttar Pradesh appear to be manufacturing powerhouses because of their proximity to NCR.

The analysis does leave open the possibility that some proportion of India's internal trade could be a consequence of current tax distortions, which are likely to be normalised under the GST. One market and greater tax policy integration but less actual trade is an intriguing future prospect.

This chapter is organized as follows.

In Section 1, the findings on Trade are documented and Section 2 examines the Constitutional provisions on promoting internal integration by comparing it with other models. The extent to which the Constitutional provisions facilitate the creation of one economic India is discussed in a final section. The open question is whether laws can more proactively facilitate the economic integration of India or not.

Technical Terms

A. **Goods and Services Tax (GST)** refers to the single unified tax created by amalgamating a large number of Central and State taxes presently applicable in India. The latest constitution Amendment Bill of December 2014 made in this regard, proposes to insert a definition of GST in Article 366 of the constitution by inserting a sub-clause 12A. As per that, GST means any tax on supply of goods, or services, or both, except taxes on supply of the alcoholic liquor for human consumption. And here, services are defined to mean anything other than goods.

GST is a single tax on the supply of goods and services, right from the manufacturer to the consumer. Credits of input taxes paid at each stage will be available in the subsequent stage of value addition, which makes GST essentially a tax only on value addition at each stage. The final consumer will thus bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages.

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B. **The Central Sales Tax (CST)** is a levy of tax on sales, which are effected in the course of inter-State trade or commerce. According to the Constitution of India, no State can levy sales tax on any sales or purchase of goods that takes place in the course of interstate trade or commerce. Only parliament can levy tax on such transaction. The Central Sales Tax Act was enacted in 1956 to formulate principles for determining when a sale or purchase of goods takes place in the course of interstate trade or commerce. The Act also provides for the levy and collection of taxes on sale of goods in the course of interstate trade and commerce and to declare certain goods to be of special importance in the interstate commerce or trade.

The central sales tax is an indirect tax on consumers. Though CST is a central levy, however it is administered by the concerned State in which the sale originates. The seller or a dealer of goods in a State has to collect State Sales Tax on the sale of goods within the State as well as central Sales Tax on sales that takes place in the course interstate trade or commerce.

C. **Value Added Tax (VAT)** is a kind of tax levied on sale of goods and services when these commodities are ultimately sold to the consumer. VAT is an integral part of the GDP of any country. While VAT is levied on sale of goods and services and paid by producers to the government, the actual tax is levied from customers or end users who purchase these. Thus, it is an indirect form of tax which is paid to the government by customers but via producers of goods and services.

VAT is a multi-stage tax which is levied at each step of production of goods and services which involves sale/purchase. Any person earning an annual turnover of more than Rs.5 lacs by supplying goods and services is liable to register for VAT payment. Value added tax or VAT is levied both on local as well as imported goods.

D. **General Agreement on Tariffs and Trade (GATT),** set of multilateral trade agreements aimed at the abolition of quotas and the reduction of tariff duties among the contracting nations. By the time GATT was replaced by the World Trade Organization (WTO) in 1995, 125 nations were signatories to its agreements, which had become a code of conduct governing 90 percent of world trade.

GATT's most important principle was that of trade without discrimination, in which each member nation opened its markets equally to every other. As embodied in unconditional most-favoured nation clauses, this meant that once a country and its largest trading partners had agreed to reduce a tariff, that tariff cut was automatically extended to every other GATT member.

Gist of Economic Survey Chapter

While international barriers to trade have been studied extensively, less attention has been devoted to studying the impact of trading networks and other barriers (political and cultural) to trade within countries. The estimation of these barriers to intra-national trade for India has hitherto been challenging due to the absence of a comprehensive interstate trade dataset. This chapter presents the first estimates of internal trade within India using a novel data source – transactions recorded in the process of Central Sales Tax (CST) collection as provided by Tax Information Exchange System (TINXSYS).

The first-ever estimates for interstate trade ûows indicate that cross-border exchanges between and within firms amount to at least 54 per cent of GDP, implying that interstate trade is 1.7 times larger than international trade. Both figures compare favourably with other jurisdictions: *de facto* at least, India seems well integrated internally. A more technical analysis confirms this, finding that trade costs reduce trade by roughly the same extent in India as in other countries.

Balance of Interstate Trade: Net Exporters and Net Importers

The large manufacturing states – Gujarat, Maharashtra and Tamil Nadu have a positive balance of trade highlighting their competitive manufacturing capabilities. This positive balance is also a feature of Delhi

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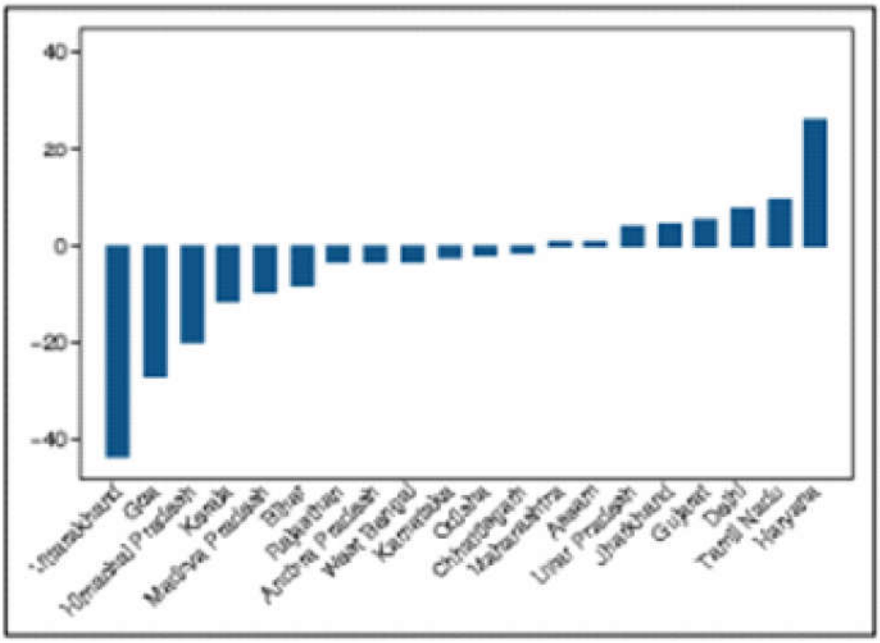
(7.4 per cent), Haryana (26.1 per cent) and UP (4.2 per cent), reûecting the large value additions occurring in the manufacturing hubs of the National Capital Region, namely Gurugram and NOIDA. Gurugram and NOIDA, respectively, make otherwise agricultural Haryana and UP manufacturing powerhouses.

Trade Balance (Net Exports as per cent of GSDP)



The CST and VAT

Under the current system, states levy a value-added tax on most goods sold within the state, the centre levies a near VATable excise tax at the production stage. Sales of goods across states fall outside the VAT system and are subjected to an origin-based non-VATable tax (the Central Sales Tax, CST). It turns out that the CST – far from acting as a tariff on interstate trade – may actually provide an arbitrage opportunity away from a higher VAT rate on intra-state sales in some cases.

Contrary to the caricature, India's internal trade in goods seems surprisingly robust. This is true whether it is compared to India's external trade, internal trade of other countries, or gravity-based trade patterns in the United States. For example, the effect of distance on trade seems lower in India than in the US. Hearteningly, it seems that language is not a serious barrier to trade. There is enormous variation across states in their internal trade patterns. Smaller states tend to trade more, while the manufacturing states of Tamil Nadu, Maharashtra and Gujarat tend to have trade surpluses (exporting more than importing). Belying their status as agricultural and/or less developed, Haryana and Uttar Pradesh appear to be manufacturing powerhouses because of their proximity to NCR. The analysis does leave open the possibility that some proportion of India's internal trade could be a consequence of current tax distortions, which are likely to be normalised under the GST. One market and greater tax policy integration but less actual trade is an intriguing future prospect.

GST

The GST was justly touted as leading to the creation of One Tax, One Market, One India. But it is worth reûecting how far India is from that ideal. Indian states have levied any number of charges on goods that hinder free trade in India—octroi duties, entry taxes, Central Sales Tax (CST) to name a few. The most

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egregious example of levying charges of services coming from other states is the cross-state power surcharge that raises the cost of manufacturing, fragments the Indian power market and sustains inefficient cross-subsidization of power within states.

In agriculture, Agriculture Produce Market Committee (APMCs) still proliferate which prevent the easy sales of agricultural produce across states, depriving the farmer of better returns and higher incomes, and reducing agricultural productivity in India. These measures in agriculture, goods, and services make light of claims that there is one economic India.

There is an obvious conceptual commonality of public policy objectives in large federations or supra-national entities: balancing the imperative of creating a common market so that all producers and consumers are treated alike, with the imperative of not undermining the legitimate sovereignty of the sub-federal units. Three comparators suggest themselves: other federal countries such as the United States; other federal structures comprising countries such as the European Union; or multilateral trading agreements such as the World Trade Organization (WTO).

India's Constitutional Provisions and Jurisprudence

That comparison requires understanding the constitutional provisions on both achieving and circumscribing the common market. Articles 301-304 provide a layered set of rights and obligations. Article 301 establishes the fundamental principle that India must be a common market:

301. **Freedom of trade, commerce and intercourse.** *Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.*

Articles 302-304 both qualify and elaborate on that principle. Article 302 gives Parliament the power to restrict free trade between and within states on grounds of public interest.

302. **Power of Parliament to impose restrictions on trade, commerce and intercourse.** *Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory of India as may be required in the public interest.*

Article 303 (a) then imposes a most-favored nation type obligation on both Parliament and state legislatures; that is no law or regulation by either can favour one state over another.

303. **Restrictions on the legislative powers of the Union and of the States with regard to trade and commerce**

(1) Notwithstanding anything in Article 302, neither Parliament nor the Legislature of a State shall have power to make any law giving, or authorising the giving of, any preference to one State over another, or making, or authorising the making of, any discrimination between one State and another, by virtue of any entry relating to trade and commerce in any of the Lists in the Seventh Schedule

Article 304 (a) then imposes a national treatment-type obligation on state legislatures (apparently not on Parliament); that is, no taxes can be applied to the goods originating in another state that are also not applied on goods produced within a state. This Article refers only to taxes and not to regulations more broadly.

304. **Restrictions on trade, commerce and intercourse among States** *Notwithstanding anything in Article 301 or Article 303, the Legislature of a State may by law:*

(a) impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or produced; and

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But then Article 304 (b) allows state legislatures to restrict trade and commerce on grounds of public interest.

(b) impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest: Provided that no Bill or amendment for the purposes of clause shall be introduced or moved in the Legislature of a State without the previous sanction of the President

Interestingly, this freedom to the states in Article 304 (b) is only different from that provided to Parliament in Article 302 in that states have to impose "reasonable restrictions" whereas Parliament may impose "restrictions." Of course, states can only impose restrictions in areas that are either on the state or concurrent list.

The gist of these provisions is that both the Centre and the States have considerable freedom to restrict trade and commerce that hinder the creation of one India.

Moreover, the jurisprudence has unsurprisingly come down in favour of even more permissiveness. Evidently, while the purpose of Part XIII was to ensure free trade in the entire territory of India, this is far from how its practical operation has panned out. Financial levies as well as non-financial barriers imposed by the States have become a major impediment to a common market. Levies in the nature of motor vehicles taxes, taxes at the point of entry of goods into specified local areas, sales tax on manufacturers of goods from outside a particular State, have always existed between States. At the same time, many of such levies are constitutionally valid and have been upheld, in principle, by the Supreme Court.

Provisions In Other Countries

USA

The United States has a very strong interstate commerce clause in the Constitution. Article I, Section 8, Clause 3 vests Congress with the power: "to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.

A combined reading of these provisions makes it apparent that even in a Constitution where residuary powers are reserved to the states (and not the Union, as is the case in India); states are constitutionally barred from regulating interstate trade and commerce as it was felt that such power would fundamentally hamper free trade and movement.

EU

Since the Maastricht Treaty that created the common market in Europe, it is now accepted that countries within the EU must not, except under narrow circumstances, restrict the four freedoms of movement: of goods, services, capital, and people. Now, it could be argued that both the USA and EU are very different from India because of their long and particular histories of nationhood: for example, it could be argued that Indian states are more diverse than states within the US and hence require greater freedom of tax and regulatory manoeuvre. The counter-argument would of course be that the American states were always fiercely jealous of their sovereignty and that the Constitution embodies that. In this view, the strong interstate commerce clause exists despite strong states. It could also be argued, with even less plausibility however, that states within India should have more regulatory freedom than sovereign countries within Europe.

WTO

There is a third and much weaker standard by which Indian rules should be assessed: the WTO. The comparison between WTO rules and the provisions of the Constitution is not inappropriate. That is, it

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is reasonable to compare the common-market/regulatory freedom balance provided for countries in the WTO with the same provided for states in the Constitution.

But the key difference with the Constitution is the freedom provided to depart from these anti-protectionism requirements. The contrast is really between Articles 302 and 304 (b) of the Constitution and Article XX of the General Agreement on Tariff and Trade (GATT) WTO.

Article XX - General Exceptions *Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:*

(a) Necessary to protect public morals;

(b) Necessary to protect human, animal or plant life or health;

(c) Relating to the importations or exportations of gold or silver;

(d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trademarks and copyrights, and the prevention of deceptive practices;

(e) Relating to the products of prison labour;

(F) Imposed for the protection of national treasures of artistic, historic or archaeological value;

(g) Relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;

(h) Undertaken in pursuance of obligations under any intergovernmental commodity agreement which conforms to criteria submitted to the CONTRACTING PARTIES and not disapproved by them or which is itself so submitted and not so disapproved;

(i) Involving restrictions on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan; Provided that such restrictions shall not operate to increase the exports of or the protection afforded to such domestic industry, and shall not depart from the provisions of this Agreement relating to non-discrimination;

(j) Essential to the acquisition or distribution of products in general or local short supply; Provided that any such measures shall be consistent with the principle that all contracting parties are entitled to an equitable share of the international supply of such products, and that any such measures, which are inconsistent with the other provisions of the Agreement shall be discontinued as soon as the conditions giving rise to them have ceased to exist…

The key point is that in the WTO the departures from a common market across widely varying countries is quite heavily circumscribed whereas similar departures between states within India is easily condoned by the Constitution and consequent constitutional jurisprudence.

At a time when India is embracing cooperative federalism, the question to ponder is this: even if India cannot embrace the strong standards of a common market prevalent in the US and EU, should not the law in India at least aspire to the weak standards of a common international market embraced by countries around the world?

Notes

Supplementary Readings

A. GST

GST is one indirect tax for the whole nation, which will make India one unified common market.

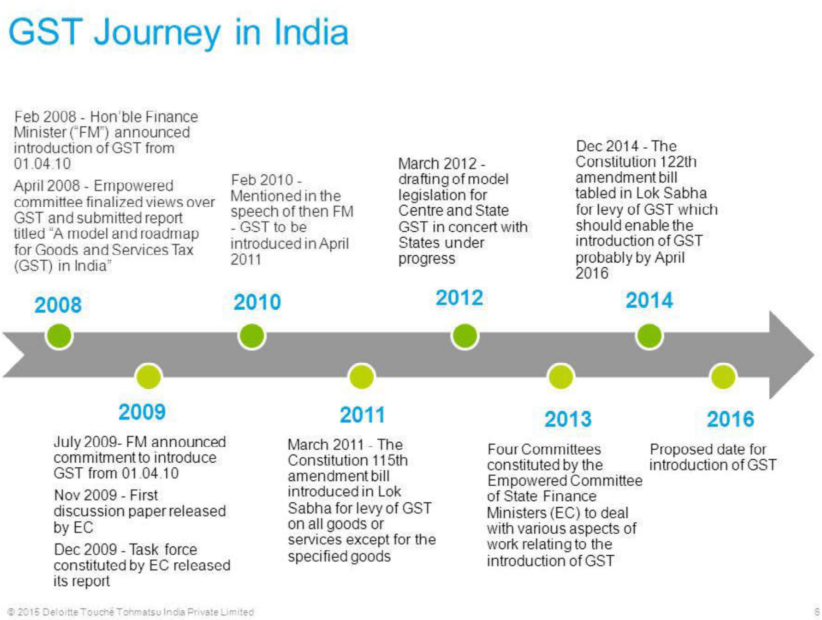
Why GST has been proposed?

Our Constitution empowers the Central Government to levy excise duty on manufacturing and service tax on the supply of services. Further, it empowers the State Governments to levy sales tax or value added tax (VAT) on the sale of goods. This exclusive division of fiscal powers has led to a multiplicity of indirect taxes in the country. In addition, central sales tax (CST) is levied on inter-State sale of goods by the Central Government, but collected and retained by the exporting States. Further, many States levy an entry tax on the entry of goods in local areas.

This multiplicity of taxes at the State and Central levels has resulted in a complex indirect tax structure in the country that is ridden with hidden costs for the trade and industry.

In order to simplify and rationalize indirect tax structures, Government of India attempted various tax policy reforms at different points of time. A system of VAT on services at the central government level was introduced in 2002. The states collect taxes through state sales tax VAT, introduced in 2005, levied on intrastate trade and the CST on interstate trade. Despite all the various changes the overall taxation system continues to be complex and has various exemptions.

This led to the idea of One nation One Tax and introduction of GST in Indian financial system. This is simply very similar to VAT which is at present applicable in most of the states and can be termed as National level VAT on Goods and Services with only one difference that in this system not only goods but also services are involved and the rate of tax on goods and services are generally the same.



B. Big Data

Big data is a term that describes the large volume of data – both structured and unstructured – that inundates a business on a day-to-day basis. But it's not the amount of data that's important. It's what

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organizations do with the data that matters. Big data can be analyzed for insights that lead to better decisions and strategic business moves.

Big data analytics is the process of examining large data sets to uncover hidden patterns, unknown correlations, market trends, customer preferences and other useful business information. The analytical findings can lead to more effective marketing, new revenue opportunities, better customer service, improved operational efficiency, competitive advantages over rival organizations and other business benefits.

The primary goal of big data analytics is to help companies make more informed business decisions by enabling data scientists, predictive modelers and other analytics professionals to analyze large volumes of transaction data, as well as other forms of data that may be untapped by conventional business intelligence (BI) programs. That could include Web server logs and Internet clickstream data, social media content and social network activity reports, text from customer emails and survey responses, mobile-phone call detail records and machine data captured by sensors connected to the Internet of Things.

C. Trade Facilitation Agreement (TFA)

Traders from both developing and developed countries have long pointed to the vast amount of "red tape" that still exists in moving goods across borders, and which poses a particular burden on small and medium-sized enterprises. To address this, WTO Members concluded negotiations on a landmark Trade Facilitation Agreement (TFA) at their 2013 Bali Ministerial Conference and are now in the process of adopting measures needed to bring the Agreement into effect.

The TFA contains provisions for expediting the movement, release and clearance of goods, including goods in transit. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area. The Agreement will help improve transparency, increase possibilities to participate in global value chains, and reduce the scope for corruption.

The TFA was the first Agreement concluded at the WTO by all of its Members.

The Trade Facilitation Agreement contains provisions for expediting the movement, release and clearance of goods, including goods in transit. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area.

D. Some of the Major Initiatives Taken by the Government in the Last Couple of Years to Improve 'Ease of Doing Business' in India

Passage of Insolvency and Bankruptcy Code: The government has managed to pass the Insolvency and Bankruptcy Code, thus clearing the last hurdle for making the code into a law. Experts believe that the law would be in place within a year. The new Bankruptcy law is supposed to significantly reduce the average time taken for the insolvency process to complete, which currently is 4.3 years.

Time for registering companies reduced: The government has made the process for registering a company faster by reducing the time taken from almost 10 days in December 2014 to 5 days in December 2015. This year the government plans to further reduce the time taken to 1-2 days.

Easier processes for incorporation: To make the process of registering and incorporating companies faster, the government has done away with the requirement of reserving a name, and integrated the processes related to allotment of Director Identification Number (DIN), appointment of directors etc in a single form (INC - 29) for incorporation of a company.

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Integration of processes through eBiz portal: The eBiz platform of the Department of Industrial Policy and Promotion (DIPP) integrates several processes across (government) departments to make the process of incorporating a company simpler. One can apply for Permanent Account Number (PAN), Tax Deduction Account Number (TAN), EPFO (Employees' Provident Fund Organization) and ESIC (Employee's State Insurance Corporation) and incorporation of company through the eBiz portal.

Doing away with requirement for minimum paid up capital: The minimum paid-up share capital requirement was Rs 1 lakh for a private company and Rs 5 lakh for a public company. This requirement has now been done away with for incorporating private as well as public companies in India.

Making tax laws simpler: The government has accepted most of the first set of recommendations of Easwar Committee for simplification of tax laws. The most important of those being exemption to non-residents from mandatorily having a PAN for lower tax deduction at source, hiking the turnover limit for availing presumptive taxation benefits from Rs1 crore to Rs 2 crore, and deferment of Income Computation and Disclosure Standards (ICDS).

Related Questions

1. Discuss the variations across states in their internal trade patterns. How can GST help to improve the situation?
2. State the various Provisions in the constitution which has principles that India must be a common market? Discuss its viability in context of common market for India?
3. How can the goal of creating one economic India be achieved? Critically Discuss.

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12 INDIA ON THE MOVE AND CHURNING: NEW EVIDENCE

Context

New estimates of labour migration in India have revealed that inter-state labor mobility is significantly higher than previous estimates.

The study based on the analyses of new data sources and new methodologies also shows that the migration is accelerating and was particularly pronounced for females. The data sources used for the study are the 2011 Census and railway passenger traffic flows of the Ministry of Railways and new methodologies including the Cohort-based Migration Metric (CMM).

Based on two new datasets and methodologies, this chapter finds high levels of internal work related migration in India. Analysing the changes in same-age cohorts using Census data yields an annual inter-state migration of about 5-6.5 million between 2001 and 2011. Railway passenger data analysis suggests an annual inter-state migration flow of close to 9 million since 2011. Clearly, rising growth after the 1980s has led to an acceleration of labour migration flows as the rewards of better economic opportunities have overcome the costs of moving.

Technical Terms

A. **Migrant:** The Census definition of a **migrant** is as follows: "When a person is enumerated in census at a different place than his/her place of birth, she/he is considered a migrant". This chapter focuses on inter-state migration.

B. **Gravity model** is an empirical observation which finds that the migrant/passenger flows between two geographies is directly proportional to the level of economic activity/population of these two geographies and inversely proportional to some measure of physical distance between the two geographies. Geographers were pioneers in using the gravity models for studying the migration and mobility patterns.

C. **Cohort** A group of people sharing a common temporal demographic experience who are observed through time. For example, the birth cohort of 1900 is the people born in that year. There are also marriage cohorts, school class cohorts, and so forth.

D. **Cohort Analysis** Observation of a cohort's demographic behavior through life or through many periods; for example, examining the fertility behavior of the cohort of people born between 1940 and 1945 through their entire childbearing years. Rates derived from such cohort analyses are cohort measures. Compare with period analysis.

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Gist of Economic Survey Chapter

Historically, migration of people for work and education has been a phenomenon that accompanies the structural transformation of economies, and has paved the way for the release of "surplus labour" from relatively low-productive agricultural activities to sectors enjoying higher productivity. The resulting remittance flows increase household spending in the receiving regions and further the economic development of less-developed regions.

Analysis of migration pattern in India:

Based on the census data it emerge that number of migrants in India is very low and not increasing. According to census -2001 data India has 33 million economic migrants, constituting around 8.1% of workforce. In China nearly 25% of workforce is migrant labour.

Some characteristics of migration in India according to census 2001 data are:

- People move from less affluent states to more affluent states
- 33 million or 8.1% of Indian workforce were migrants for economic reasons.
- Over 80% of these migrants were male.
- Labour mobility also appears to be low because urbanization rates have not picked up sharply over the years,

However new studies have contradicted census data and shown that stock of migrants in India is far more, because:

- Migration trends in India tends to be circular in nature both in short term and long term and are not captured properly by Census.
- Female migration for work is concealed in 'reason-for-migration' statistics because the principal reason given to the enumerator is 'marriage' or 'moved with household.
- Commuter migration for work across the rural-urban divide is also substantial in India, exceeding 10 million people in 2009-10.
- The slow pace of Indian urbanization is rooted in the demographic divergence between rural and urban natural growth rates and not necessarily in low or stagnant rates of migration

Alternative estimates noted above place the share of migrants in the workforce to lie between 17% and 29%. Much greater than 8.1% indicated by census 2001.

Magnitude and Pattern of migration according new estimates:

- The first-ever estimates of internal work-related migration using railways data for the period 2011-2016 indicate an annual average flow of close to 9 million people between the states.
- A new **Cohort based Migration Metric (CMM)**—shows that annually inter-state labour mobility averaged 5-6 million people between 2001 and 2011, yielding an inter-state migrant population of about 60 million and an inter-district migration as high as 80 million.
- The sum of all the out-of-state net migrants in the 20-29 age cohorts for the period 2001-11 exceeded 11 million people, up from around 6 million people in the 19912001 period. Nearly 80% of these migrants were male in both periods.

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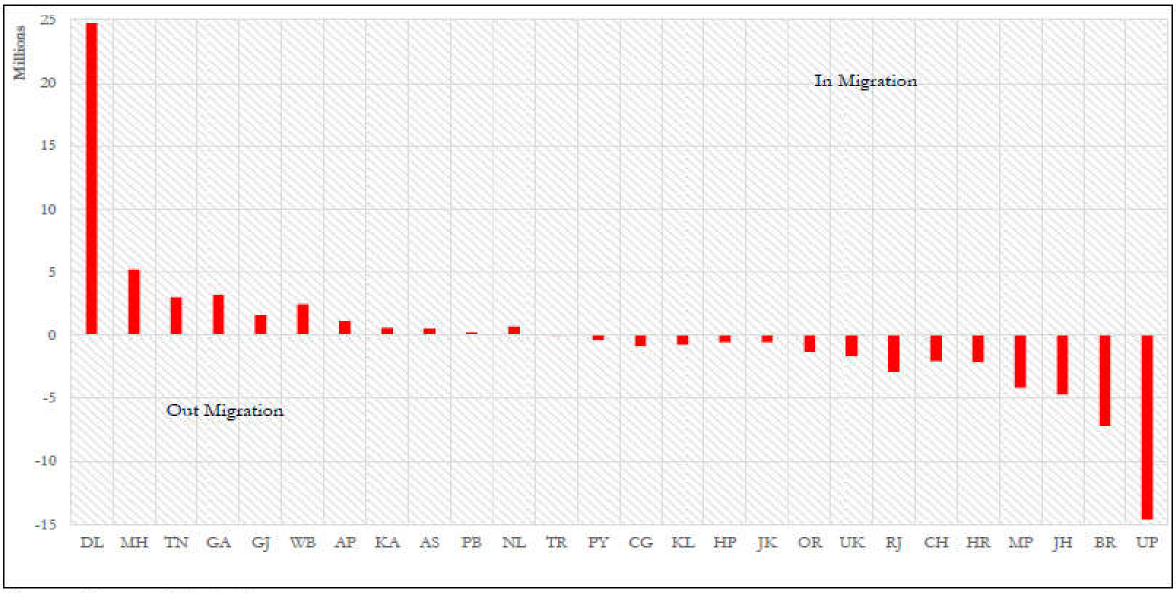
- More number of districts are witnessing net out migration.
- Another important development is the growing role of female migrants. Until the 2000s, migration was largely a male dominated phenomenon. But in the 2000s there was a marked shift in the distribution for females (indicating more outflows), indeed much more than the shift for males,
- Migration is accelerating. In the period 2001-11, according to Census estimates, the annual rate of growth of labour migrants nearly doubled relative to the previous decade, rising to 4.5 per cent per annum in 2001-11 from 2.4 per cent in 1991- 2001.
- This acceleration has been accompanied by the surge of the economy. As growth increased in the 2000s relative to the 1990s, the returns to migration might have increased sufficiently to offset the costs of moving, resulting in much greater levels of migration.
- Migrant flows between states are lower than flows within states. Estimates suggest that on average flows within states are around four times the flows across states.
- Within India, in both trade and labour flows, language doesn't seem to matter for migrants.which vindicate the founding fathers' permissive approach to India's linguistic cleavage.
- Distance has a strong negative effect on labor flows.
- The adjoining state border effect (contiguity) is positive suggesting that migration is higher in the adjacent states even after controlling for distance.
- The largest recipient was the Delhi region, which accounted for more than half of migration in 2015-16, while Uttar Pradesh and Bihar taken together account for half of total out-migrants. Maharashtra, Goa and Tamil Nadu had major net in-migration, while Jharkhand and Madhya Pradesh had major net out-migration. Southern states have witnessed increased in-migration trends.



Source: Survey Calculations

Net migration across states

One significant anomaly given by data is that Kerala in appears to be a net exporter of migrants between 2011-12 and 2015-16 which runs counter to priors.

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Conclusion

An India on the move is an India of churn, as Dr. Ambedkar observed. According to new studies there is higher level of labour mobility in India and acceleration of migration was more pronounced in female labour and increased at nearly twice the rate of male migration in the 2000s.

The numbers show that internal migration has been rising over time, nearly doubling in the 2000s relative to the 1990s. One plausible hypothesis for this acceleration is that the rewards (in the form of prospective income and employment opportunities) have become greater than the costs and risks that migration entails.

This acceleration has taken place in the backdrop of discouraging incentives such as

- Domicile provisions for working in different states,
- Lack of portability of benefits, legal and other entitlements upon relocation.

To sustain this churn, however, these policy hurdles have to be overcome.

- Portability of food security benefits, healthcare, and
- A basic social security framework for the migrant is crucial – potentially through an interstate self registration process.

While there do currently exist multiple schemes that address migrant welfare, they are implemented at the state level, and hence require inter-state coordination of fiscal costs of migration.

The domestic remittances market, estimated to exceed Rs. 1.5 lakh crores, can also be leveraged to enhance financial inclusion formigrant workers and their families in the source region. Such measures would vastly enhance the welfare gains of migration and encourage even greater integration of labour markets in India.

Supplementary Readings

A. Cohort Migration Methodology

Most migration analyses focus on net migration and are concerned with areal redistributions of population. Migration may also be studied as an event in the life-cycle of an individual, and migration rates may be defined as properties of cohorts.

It uses following data:

1. Cohort-based Migration Metric (CMM) CMM (t) = 100 x [Population in 20-29 age cohort in Census(t) – Population in 10-19 age cohort in Census(t-10) - Cohort Mortality]/ Population in 10-19 age cohort in Census(t-10) Cohort Mortality= 10 x Age-specific (10-19) mortality rate per year x Population in 10-19 age cohort in Census(t-10) Data Source: Population data from the Census 1991, 2001 and 2011 and age-specific mortality data (State level) for the 10-19 age group for the years 1996 and 2006 from Sample Registration System statistics. CMM is calculated at the district and state levels. At the State level, population for Kerala is corrected for international migration using data from the Kerala Migration Surveys conducted by CDS, Kerala.

B. The impact of migration on migrants livelihood

Poorer migrant workers, crowded into the lower ends of the labour market, have few entitlements vis a vis their employers or the public authorities in the destination areas. They have meagre personal assets

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and suffer a range of deprivations in the destination areas. In the source areas, migration has both negative and positive consequences for migrants and their families.

Migration has both positive and negative impacts on the destination country.

Advantages:

- **Cheap labour:** Migrants often do many unskilled jobs for a very little wage. Skilled migrants are also often happy to give their services for little salary.
- **Skilled labour:** Some immigrants are highly skilled and talented, and they contribute to knowledge and production for the well-being of all in that country.
- **Cultural diversity:** Immigrants provide the diversity in many palaces. Diversity helps cultures and traditions to loosen the grip on racism; discrimination etc. diversity helps people learn about other way of life and what goes on in other places of the world. It brings variety to almost every part of our ways of life. Diversity helps people to better appreciate humanity and human right s in general.

Disadvantages:

- **Loss of job:** Immigrants may also cause pressure on job issues as the locals often lose jobs to incoming workers.
- **Discrimination/racism:** Immigration can fuel racism and discrimination. Immigrants who cannot speak the local languages r do not behave like the locals often find themselves not accepted in their communities, as people prefer not to have anything to do with them.
- **Social/civil pressure:** Housing, health, education and many other facilities may suffer from the pressure of excessive use by more people than it was designed to take. This can force prices of such amenities to go high, causing hardship to all.
- **Breakdown of culture and traditions:** Tradition and cultures are negatively midfields because of diversity. Sometimes healthy ways of life are lapsed as different people are exposing to different ways of doing things. Sometimes new crime incidents emerge or increase as a result of bad people coming in.
- **Diseases:** A long as people move from place to place, there is a risk of contagious disease outbreak.

Related Questions

1. What are various factors which determine migration? Assessing the recent trends in migration explain what has been the effect of liberalization on migration trends in India?
2. Though India has witnessed increased levels of migration, but there are certain factors which inhibits migration. What are such factors? What can be done to overcome these factors?

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13 THE 'OTHER INDIA'S': TWO ANALYTICAL NARRATIVES (REDISTRIBUTIVE AND NATURAL RESOURCES) ON STATES' DEVELOPMENT

Context

This chapter examines whether the pathologies associated with foreign aid and natural resources also affect the Indian states.

The Indian growth take-off since 1980 is associated with Peninsular India being close to the ocean--which development experience has long confirmed as conferring special advantages. These states-Gujarat, Maharashtra, Tamil Nadu, Karnataka, Kerala, and Andhra Pradesh-have indeed grown faster and advanced more rapidly economically. As a result, they have also been a greater focus of policy and research attention in comparison to other states- the so called 'Other Indias'. These states include not just hinterland India (the India of rivers) but also the India of forests, of natural resources, and of 'Special Category' status. This chapter is devoted to those states that have not been at the mainstream of India's development narrative. But the analysis is conducted through the lens of broader development experience.

Successful Peninsular India has offered three interesting and different models of development: the traditional East Asian mode of escape from development based on manufacturing (Gujarat and Tamil Nadu); the remittance-reliant mode of development exemplified by Kerala; and the distinctive, "Precocious India" model based on specializing in skilled services (Karnataka, Andhra Pradesh and Tamil Nadu.

Technical Terms

A. **'Special Category' state**: The concept of a **'Special Category' state,** first introduced in 1969, sought to provide disadvantaged states (those, due to several factors, were unable to generate enough resources for development) with preferential treatment in the form of central assistance and tax breaks. The states of Assam, Nagaland Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura, Uttarakhand and Jammu & Kashmir were given special status. Major factors that determined the grant for special status have been: (i) hilly and difficult terrain; (ii) low population density/sizeable share of tribal population; (iii) strategic location along international borders; (iv) economic and infrastructural backwardness; and (v) non-viable state finances.

B. **'Redistributive Resource Transfers' (RRT)** to a state is defined as gross devolution3 to the state adjusted for the respective state's share in aggregate gross domestic product (definition D1).This

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adjustment is made to ensure that only the portion of resources devolved to the states over and above their contribution to Gross Domestic Product is included as RRT.

Gist of Economic Survey Chapter

In India peninsular states, also having coastal boundary followed the three different model of development i.e. the traditional East Asian mode of escape from development based on manufacturing (Gujarat and Tamil Nadu); the remittance-reliant mode of development exemplified by Kerala; and the distinctive, "Precocious India" model based on specializing in skilled services (Karnataka, Andhra Pradesh and Tamil Nadu).

However, other states (hinterland India, India of forest and natural resources and of special categories status) have been less successful. This chapter analyse the model of development of other states i.e. those based on "aid" or special status, and those based on natural resources. The "aid" model is most applicable to the erstwhile 'Special Category' states that include North-eastern states and Jammu and Kashmir; the natural resources model to Jharkhand, Chhattisgarh, Odisha, Gujarat, and Rajasthan.

'Special Category' state, first introduced in 1969. Major factors that determined the grant for special status have been:

(i) Hilly and difficult terrain;

(ii) Low population density/sizeable share of tribal population;

(iii) Strategic location along international borders;

(iv) Economic and infrastructural backwardness; and

(v) Non-viable state finances

Impact of Redistributive Resources

Development model based on foreign aid has not been successful internationally, hypothesis which explains it that aid perpetuates resource dependency, in the sense that since revenues flow in from outside, recipient countries may fail to develop their own tax bases or their institutions more generally. And it is institutions, tax revenues, and incentives that have been found to be critical for growth, much more than overall resource availability.

Though India itself did not followed this model and tried to rely on its resources as much as possible, with the aim of winding down its aid dependence as quickly as possible, however within India, It has provided extensive transfers to certain poorer states in an attempt to spur their development.

Redistributive Resource Transfers: Evidence from Indian States

State governments up to now have received funds from the Centre via different channels: (i) a share of central taxes, as stipulated by Finance Commissions; (ii) plan and non-plan grants; and (iii) plan and non-plan loans and advances. These funds constitute "gross devolution to states" and the entire amount is not "aid". Gross devolution entails a strong redistributive element. The 'Special Category' states have been heavily dependent on such flows for their developmental needs vis-à-vis other states.

- The perspective utilized in this chapter does recognize that transfer of resources to states is done to avert regional inequalities and correct fiscal imbalances and is therefore extremely crucial.
- In this light, this chapter utilizes the concept of 'Redistributive Resource Transfers' (RRT). RRT to a state is defined as gross devolution to the state adjusted for the respective state's share in aggregate

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gross domestic product. Thus RRT is not identical to gross devolution. This adjustment is made to ensure that only the portion of resources devolved to the states. Over and above their contribution to Gross Domestic Product is included as RRT. RRT is one specific measure of transfers, and is not a definitive metric of redistribution.

- The relationship between RRT, gross devolution to per capita GSPD, per capita expenditure is analysed. It is found that poorer states receive the highest transfers, exactly as one would expect. However, despite such flows over the past few decades most of the high RRT recipient states (excluding Himachal Pradesh and Uttarakhand) are at lower levels of per capita GSDP. The higher the RRT, The slower is growth, the smaller is the share of manufacturing in GSDP, The lower its own tax revenues.

Even on part of quality of governance, The RRT found negative relationship.

Redistributive Resource Transfers' (RRT) to a state is defined as gross devolution to the state adjusted for the respective state's share in aggregate gross domestic product.

RRT can be defined as the gross devolution net of the amount the state would have received as per its contribution in the country-wide fiscal effort measured by the state's share in aggregate own tax revenue.

The top 10 recipients are: Sikkim, Arunachal Pradesh, Mizoram, Nagaland, Manipur, Meghalaya, Tripura, Jammu and Kashmir, Himachal Pradesh and Assam (all 'Special Category' states).

Annual per capita RRT flows for all the north-eastern states (except Assam) and Jammu and Kashmir have exceeded the annual per-capita consumption expenditure that defines the all-India poverty lines, especially the rural.

Impact of Natural Resources

- Initially, economists saw natural resources as a way out of the low saving-low capital development trap, however it was found the that economies with abundant natural resources have actually tended to grow less rapidly than resource scarce economies. Economic geographer Richard Auty coined the phrase "resource curse" in 1993 to describe this phenomenon.
- Three possible explanations were provided for it first, the exploitation of natural resources generates rents, which lead to rapacious rent-seeking (the voracity effect) and increased corruption. Second, natural resource ownership exposes countries to commodity price volatility, which can destabilise GDP growth.
- Finally, natural resource ownership – like foreign aid — makes countries susceptible to "Dutch Disease" named after the impact that discovery of natural gas in the North Sea had on the domestic economy in the Netherlands. This windfall caused the real exchange rate to appreciate as the extra income was spent domestically, pushing up the price of non tradables, such as services geared to the local economy. The higher prices for services then eroded profitability in export and import-competing industries, de-industrialising the economy, with the share of manufacturing in the economy falling. Similar effects have occurred in Canada, Australia, Russia, and Africa.
- This approach can also be applied to some Indian states which were bifurcated in 2000 – Chhattisgarh was split off from Madhya Pradesh, Uttarakhand from Uttar Pradesh, and Jharkhand from Bihar. In this process, mineral wealth was reallocated in favour of the newly created states (nearly all of Bihar's mineral wealth going to Jharkhand; for example), creating a natural experiment that can be studied profitably.

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Natural Resources and Evidence from Indian States

For this purpose, the share of minerals (in value terms) per capita in 2014, the value of minerals is the sum total of fuels (coal, lignite, crude petroleum [onshore only] and natural gas), all metallic minerals, non-metallic minerals as well as other minor minerals are considered. As per this definition the mineral resource rich states are: Jharkhand, Chhattisgarh, Odisha, Rajasthan and surprisingly Gujarat.

- On analysing the relationship between availability of resources and reduction in poverty in mineral rich states compared to other it was found that the mineral rich states seem relatively successful. Their poverty ratio fell by around 31 percentage points over nearly two decades, compared with 28.5 percentage points in the other states however the gains were not passed on equally to all sections of the population. In particular, the Scheduled Tribes (ST) population of the mineral-rich states, which actually forms the predominant population in these areas, saw only a 17 percentage point decline in poverty, smaller than the 22 percentage point fall in the other states.
- Based on the analysis, there seems to be no concrete evidence either in favour or against a "resource curse" in the context of Indian states. The results are, however, relatively strong for levels of per capita GSDP and consumption. With regards to manufacturing share and governance, even though there is no negative correlation, it must be emphasized that there is no strong positive relation either. This implies that the resource rich states need to bolster efforts to counter any possible downsides of a "resource curse" that may emerge in the future.

"Resource curse" economies with abundant natural resources have actually tended to grow less rapidly than resource scarce economies.

Three possible **reasons for resource curse** are-

- First, the exploitation of natural resources generates rents, which lead to rapacious rent-seeking (the voracity effect) and increased corruption.
- Natural resource ownership exposes countries to commodity price volatility, which can destabilise GDP growth.
- Natural resource ownership – like foreign aid – makes countries susceptibleto "Dutch Disease".

There is no direct evidence to support "Resource curse "in India.

Conclusion

It is, of course, possible, that the "RRTcurse" and "natural resource curse", to theextent they are valid, could be a result ofpoor connectivity in particular and poorinfrastructure - physical, financial, and digitalingeneral that most of these states suffer from. This is clearly true of the north-east but also true of many parts of resource-rich India. Enhancing connectivity - financial and physical - on a war footing (as the government has attempted for financial inclusion with the Pradhan Mantri Jan Dhan Yojana (PMJDY), expediting the optical fibre network, etc.) will have a moderating effect.

Some important policy recommendation can be a number of factors that can be taken in the account while determining the quantum and architecture of redistributive resource flows to the states. In the spirit of cooperative federalism these proposals can be suitably modified to address the priorities and concerns of various states. For example

- Redirecting flows to households as part of a Universal Basic Income (UBI) scheme,
- Conditioning transfers on fiscal performance as recommended by 13th FC

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- Making governance- contingent transfers.

On part of natural resource revenue, there is a need to improve governance, to ensure a more productive use of the resources, especially in the states that are relying so heavily on them. The structure of revenue administration as it stands today is such that the government receives royalty from the mining of mineral resources. However, in the present system there is further scope to bolster citizen engagement in sharing the fruits of resource extraction. Robust mechanisms of citizen engagement will act as a constraint on large scale corruption and over-exploitation of resources.

Establishment of a trust, to be called the District Mineral Foundation (DMF) for districts affected by mining related operation, a dedicated Fund to which all mining revenue must accrue and an alternative structure to redistribute the gains from resource use directly into the accounts of the concerned citizens as part of a UBI can be the ways for better redistribution.

Supplementary Readings

A. Special category status to states: Meaning and demand

The concept of a special category state was first introduced in 1969 when the 5th Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. Initially three states Assam, Nagaland and Jammu & Kashmir were granted special status but since then eight more have been included (Arunachal Pradesh, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, Tripura and Uttarakhand). The rationale for special status is that certain states, because of inherent features, have a low resource base and cannot mobilize resources for development.

The criteria for granting special status are as follows:

Some of the features required for special status are: (i) hilly and difficult terrain; (ii) low population density or sizeable share of tribal population; (iii) strategic location along borders with neighbouring countries; (iv) economic and infrastructural backwardness; and (v) non-viable nature of state finances. The decision to grant special category status lies with the National Development Council, composed of the Prime Minster, Union Ministers, Chief Ministers and members of the Planning Commission, who guide and review the work of the Planning Commission.

The special category states have some distinct characteristics. They have international boundaries, hilly terrains and have distinctly different socio-economic developmental parameters. These states have also geographical disadvantages in their effort for infrastructural development. Public expenditure plays a significant role in the Gross State Domestic Product of the states. The states in the North-East are also late starters in development. In view of the above problems, central government sanctions 90 percent in the form of grants in plan assistance to the states in special category. The most important prescription for special category states is interest free loan with rationalization of public expenditure based on growth enhancing sectoral allocation of resources.

Advantages of getting special category status

- Preferential treatment in federal assistance and tax break.
- Significant excise duty concessions. Thus, these states attract large number of industrial units to establish manufacturing facilities within their territory leading to their economy flourishing.
- The special category states do not have a hard budget constraint as the central transfer is high.
- These states avail themselves of the benefit of debt swapping and debt relief schemes (through the enactment of Fiscal Responsibility and Budget Management Act) which facilitate reduction of average annual rate of interest.

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- Significant 30% of the Centre's gross budget goes to the Special category state.
- In centrally sponsored schemes and external aid special category states get it in the ratio of 90% grants and 10% loans. For the rest of the states as per the recommendations of the 12th Finance Commission, in case of centrally sponsored schemes only 70% central funding is there in the form of grant. The rest of the states receive external aid in the exact ratio (of grants and loans) in which it is received by the Center.

Following the constitution of the NITI Aayog and the recommendations of the Fourteenth Finance Commission (FFC), Central plan assistance to SCS States has been subsumed in an increased devolution of the divisible pool to all States . The FFC also recommended variables such as "forest cover" to be included in devolution, with a weightage of 7.5 in the criteria and which could benefit north-eastern States that were previously given SCS assistance. Besides, assistance to Centrally Sponsored Schemes for SCS States was given with 90% Central share and 10% State share.

Related Questions

1. Why development model through foreign aid is seen as unsuccessful at international level? Identify the impact of Redistributive Resource Transfers (RRT) on Indian states with suitable examples.
2. Having good natural resources have also been termed as "resource curse". What are the possible explanations behind it? Analyse whether India is also suffering from it?

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14 FROM COMPETITIVE FEDERALISM TO COMPETITIVE SUB-FEDERALISM: CITIES AS DYNAMOS

Context

In India urbanisation is rapidly on the rise. As recently as 1991, there were only 220 million Indians living in cities, equivalent to about one-quarter of the population. By 2011, there were no less than 380 million, living in around 8,000 cities/towns, at least 53 of which were home to over 1 million people. Urban Indians now form about one-third of the population - and they produce more than three-fifths of the country's GDP.

The rise in urbanisation is mainly due to rapid rural-urban migration which poses tremendous challenges for government, particularly the municipalities who will be primarily responsible for providing the services that the new migrants - and established residents - will need.

The development of ULBs is must and for that competition at sub-federalism level is must.

Technical Terms

A. **India Infrastructure Index:** Asia Index Pvt. Ltd, a joint venture between S&P Dow Jones Indices LLC and BSE Ltd, launched its S&P BSE India Infrastructure Index. This index comprises top 30 companies based on market capitalization from five sectors—energy, transportation, non-banking financial companies (NBFCs), telecommunications and utilities. All the 30 stocks in the index will be picked from the universe of S&P BSE 500 index. It will measure the performance of major listed infrastructure companies in India. The other infrastructure index in the country is the National Stock Exchange's CNX Infrastructure Index.

B. **Public Disclosure Law:** The enactment of Public Disclosure Law refers to making appropriate provisions in the state level municipal statute(s) and/or other state-level statutes to ensure that these disclosures are mandatory.

The core objectives of Public Disclosure Law are:

- To provide appropriate financial and operational information on various municipal services to citizens and other stakeholders.
- To promote efficiency and consistency in the delivery of public goods and services by the municipality.
- To enable comparison over time (of a particular ULB) and space (between ULBs) by disseminating information in a structured, regular and standardized manner.

Notes

C. Property Tax: Property tax is the annual amount paid by a land owner to the local government or the municipal corporation of his area. The property includes all tangible real estate property, his house, office building and the property he has rented to others.

In India, the municipal corporation of a particular area assesses and imposes the property tax annually or semi annually. The tax amount is based on the area, construction, property size, building etc. The collected amount is mainly used for public services like repairing roads, construction schools, buildings, sanitation.

Central government properties and vacant property are generally exempt. Property tax comprises taxes like lighting tax, water tax and drainage tax.

D. Geographic Information Systems: Geographic Information Systems is a computer-based tool that analyzes, stores, manipulates and visualizes geographic information on a map. GIS can use any information that includes location. The location can be expressed in many different ways, such as latitude and longitude, address, or ZIP code. Many different types of information can be compared and contrasted using GIS.

E. Zipf's law: The law claims that the city with the largest population in any country is generally twice as large as the next-biggest; three times the size of the third biggest, and so on. In other words, the nth ranked city would be 1/nth the size of the largest city. This does not hold good for India. There are many reasons why the large cities are unusually small. One explanation might be that their infrastructure is overburdened. Another is that India is land scarce relative to most countries, discouraging migration particularly because distorted land markets render rents unaffordable.

Gist of Economic Survey Chapter

- Competition between states is becoming a powerful dynamics of change and progress, that dynamic must extend to competition between states and cities, and between cities.
- A large part of the difference in the levels of urbanisation seen between India and China can be mainly attributed to the different levels of development of each country. Contrary to perception, India and China have had very similar trends of urbanisation.
- The primary responsibility for development of urban areas lies with the state governments and the municipal corporations, municipalities and nagar panchayats, commonly known as urban local bodies (ULBs). These levels of government face major and inextricably linked problems: poor governance capacities, large infrastructure deficits and inadequate finances.
- **Challenges in front of ULB's-**
  - o Governance challenge
    - a) Functional overlap
    - b) Fragmentation of responsibilities and service delivery across a gamut of institutions
    - c) Transparency/ accountability issues
    - d) Poor e-governance initiatives
  - o Infrastructure deficit
    - a) Challenge related to water and power supply, waste management, public transport, education, healthcare, safety, and pollution.

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o Devolution of financial powers

a) ULBs by and large have not been able to levy adequate user charges to cover even the operation and maintenance costs.

- There is much greater variation across states than across cities in expenditure per capita. What is most striking is the low level of ULB per capita expenditure as compared to state per capita expenditure, with a few exceptions such as Mumbai, Kanpur, and Kolkata. Either states are not devolving adequate financial resources to ULBs.
- To increase revenue of ULB's property tax is the most important factor there are problems of low coverage, low rates, low collection efficiency, loss on account of exemptions, lack of indexation of property values and poor enforcement.
- Challenges to the property tax collection include inaccurate enumeration and likely under-valuation. Collection is also hampered by lack of adequate staff in the revenue department in many ULBs. **Geographical Information System (GIS) technology based Big Data solutions** can greatly help in assessing the total built-up area in a city.
- Issuing municipal bonds has been challenging owing to the poor state of ULB finances and governance.
- There is actually a negative relationship between having a directly elected Mayor and the availability of services. There also does not seem to be a strong correlation between mayoral tenure and outcomes.
- One possible reason could be that a directly elected Mayor can function effectively only if he/she has the support of majority members of the municipal council, which is not always the case. Considering this fact, two state governments namely, **Rajasthan and Tamil Nadu,** have amended their respective municipal act to provide for **indirect mayoral elections**.
- The **three lessons from Gurgaon and Jamshedpur experience** are:

i) A system of proprietary, competitive cities can combine the initiative and drive of private development with the planning and foresight characteristic of the best urban planning. A handful of proprietary cities built within a single region would create a competitive system of proprietary cities that build, compete, innovate, and experiment.

ii) The private sector has to bear the burden of higher transaction costs, if the city is managed by multiple authorities, each having greater power and competing to extract rent. The transaction costs would also be higher if initial cohesive development plan for the city is not put in place. Post-growth infrastructure development costs are much higher and at times prohibitive.

iii) The active role of civil society can prevent excessive exploitation of resources and reduce the impact negative externalities associated with rapid urbanisation. In Gurgaon, there has been a slow emergence of citizens groups, environmental groups

Conclusion

- Municipalities that have generated more resources have been able to deliver more basic services. The states should, therefore, empower cities to levy all feasible taxes.
- Municipalities also need to make the most of their existing tax bases. There is a need to adopt the latest satellite based techniques to map urban properties. The Government should leverage the Indian Space Research Organization (ISRO)/National Remote Sensing Agency (NRSA) to assist ULBs in

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implementing GIS mapping of all properties in the area of a ULB. Property tax potential is large and can be tapped to generate additional revenue at city level.

Supplementary Readings

A. Recent initiatives by the Government provide opportunities for urban rejuvenation

The Fourteenth Finance Commission (FFC) grant to ULBs for 2015-2020 is almost 277 per cent higher than the grant recommended by its predecessor. With the higher devolution of taxes to the states and grants to the ULBs, the overall public funds available for urban rejuvenation have increased. As a follow to the flagship programme (JNNURM) started by the Centre in 2005 across 65 cities, the Government has launched several new initiatives to rejuvenate urban areas. Some of the key schemes are - Smart Cities Mission, AMRUT, Swachh Bharat Mission (SBM), HRIDAY, Digital India, Skill development, Housing for All, Metro transport etc. The emphasis is now laid on strong convergence between area based and project-based schemes so as to exploit synergy and optimize benefits while avoiding costs overlap.

- **Smart Cities Mission**

Smart Cities Mission (SCM) is a holistic city rejuvenation programme for 100 cities in India, The SCM initially covers five years (2015-16 to 2019-20) and may be continued thereafter based on an evaluation. Under the SCM, the core infrastructure elements in a smart city include: i) adequate water supply, ii) assured electricity supply, iii) sanitation, including solid waste management, iv) efficient urban mobility and public transport, v) affordable housing, especially for the poor, vi) robust IT connectivity and digitalization, vii) good governance, especially e-Governance and citizen participation, viii) sustainable environment, ix) safety and security of citizens, particularly women, children and the elderly, and x) health and education. The strategic components of area-based development in the SCM are city improvement (retrofitting), city renewal (redevelopment) and city extension (greenfield development) plus a pan-city initiative in which smart solutions are applied covering larger parts of the city.

- **AMRUT**

Atal Mission for Rejuvenation and Urban Transformation (AMRUT) was launched on 25.06.2015 to improve basic urban infrastructure in 500 cities/ towns which would be known as Mission cities/ towns. The Mission is being operated for five years from financial year 2015–16 to 2019–20 and aims to cover all cities and towns with a population of over one lakh with notified Municipalities, including Cantonment Boards (civilian areas) and certain other cities like capital towns, some cities on stem of main rivers and tourist and hill destinations. The components which are to be covered under the Mission are: water supply, sewerage, septage, storm water drains, urban transport, in particular, with the focus on facilities for non-motorised transport and development of green space and parks with special provision for children-friendly components in 500 cities & towns.

- **HRIDAY**

The Government launched the National Heritage City Development and Augmentation Yojana (HRIDAY) scheme on 21st January, 2015, with a focus on holistic development of heritage cities. The scheme aims to preserve and revitalise soul of the heritage city to reflect the city's unique character by encouraging aesthetically appealing, accessible, informative and secured environment. With a duration of 27 months (completing in March 2017) and a total outlay of Rs. 500 crore, the scheme is being implemented in 12 identified cities namely, Ajmer, Amaravati, Amritsar, Badami, Dwarka, Gaya, Kanchipuram, Mathura, Puri, Varanasi, Velankanni and Warangal. The scheme is implemented in a mission mode.

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· **Swachh Bharat Mission**

The Swachh Bharat Mission (SBM) was launched on 2nd October, 2014, with a target to make the country clean by 2nd October, 2019. All 4041 statutory towns as per census 2011 are covered under SBM. The programme includes elimination of open defecation, conversion of unsanitary toilets to pour flush toilets, eradication of manual scavenging, municipal solid waste management and bringing about a behavioural change in people regarding healthy sanitation practices. Under the solid waste management state/cities are being encouraged to come out with innovative solutions and MoUD supports them technically and financially. Some of the initiatives being taken are waste to energy, composting plants, capping of the dumpsites. All the initiatives are being supported by capacity building efforts to empower the Municipal Authorities to carry out their functions properly.

B. Municipal Bonds

A municipal bond is a debt obligation issued by a local authority with the promise to pay the bond interest on a speciûed payment schedule and the principal at maturity.

They can be either general obligation bonds, where the principal and interest are guaranteed by the issuer's overall tax revenues or they can be revenue bonds, where the principal and interest are secured by revenues from a particular project of the ULBs. It could be derived from tolls, charges or rents from the facility built with the proceeds of the bond issue.

Benefits of Municipal Bond

Municipal bonds have advantages in terms of the size of borrowing and the maturity period which may extend up to 20 years.

Both these features are suitable for urban infrastructure financing. Further, if properly structured, municipal bonds can be issued at interest costs that are lower than the risk-return profile of individual.

The municipal bond mode of financing allows both the borrowers and the lenders to have greater flexibility.

Local government bond issuers are likely to be less restricted by annual budget cycles and the capital grants' decisions of higher levels of government. Further, they can unbundle their functions, which enables them to make separate decisions about the placement of their liquid deposits and about obtaining advice regarding the financial and/or technical components of their infrastructure projects. However, it should be noted that the danger of such unbundling is that a credit partner who understands various aspects, especially the financial impacts of different activities of the ULB on each other, would be absent. The flexibility available to the lenders arises out of the possibility of trading municipal bonds prior to the end of their tenor in the secondary bond market. Liquidity in such a market is essential for the development of the primary municipal bond market. However, the advantages of municipal bond market can only be realized when a sound fiscal and regulatory framework is structured for developing the market. Such a framework would clarify various aspects of this market, such as ex ante borrowing activities of ULBs, ex post procedures regarding municipal default and insolvency, and domains that involve shared responsibilities between different levels of government in a federal state.

C. Application of GIS in urban Planning

Geographic Information Systems is a computer-based tool that analyzes, stores, manipulates and visualizes geographic information on a map.

GIS can also be helpful for the documentation of spatial plans and in the approval process for the development, building and installation permits.

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GIS applied to a wide range of land management and land use planning issues including the interpretation and formulation of land use policy. Land-use policy can be interpreted within GIS using a modelling approach.

Example: Urban planning requires including many layers of detail on a single map, and one of the features of a GIS is multilayered mapping. Each of these layers has different types of information and data associated with it. A municipal planning committee can use a GIS to see a variety of different things, including prime agricultural land, surface water, high flood frequency, and highly erodible land. This multilayered capability can make a big difference when developing an area, for example places with high flood frequency could lead to high flood insurance premiums for residents, which may detract from people wanting to live there.

GIS is also useful in monitoring of an area or conducting a feasibility study of a location for a specific purpose e.g. ascertaining the suitability of a location for the construction of a bridge or dam. Feasibility study of even smaller structures like schools and hospitals is essential and can be easily conducted with the help of GIS.

Related Questions

1. Examine the major sources of revenue for municipal/ Urban-Local bodies? Also identify the discrepancies between states as per financial strength of their local bodies?
2. Discuss the steps taken by government and finance commissions to supplement the revenues of the local bodies? Analyse why still most of such bodies are financially very weak?

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