INTRODUCTORY ECONOMICS II

III/IV SEMESTER

2019 Admission onwards
CBCSS

BA HISTORY/BA POLITICAL SCIENCE

COMPLEMENRY COURSE
(ECO4(3) C01)

UNIVERSITY OF CALICUT

School of Distance Education,
Calicut University (P.O), Malappuram, Kerala, India 673635

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SCHOOL OF DISTANCE EDUCATION

Study Material

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INTRODUCTORY ECONOMICS I

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MODULE-I
MONEY AND BANKING

Introduction

The word 'money' is derived from the Latin word 'Moneta' which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greeks used coins as money.

Stages in the evolution of money

The evolution of money has passed through the following five stages depending upon the progress of human civilization at different times and places.

1. Commodity money

Various types of commodities have been used as money from the beginning of human civilization. Stones, spears, skins, bows and arrows, and axes were used as money in the hunting society. The pastoral society used cattle as money. The agricultural society used grains as money. The Romans used cattle and salt as money at different times. The Mongolians used squirrel skins as money. Precious stones, tobacco, tea shells, fishhooks and many other commodities served as money depending upon time, place and economic standard of the society.

The use of commodities as money had the following defects.

- All the commodities were not uniform in quality, such as cattle, grains, etc. Thus lack of standardization made pricing difficult.
- It is difficult to store and prevent loss of value in the case of perishable commodities.
- Supplies of such commodities were uncertain.
- They lacked in portability and hence were difficult to transfer from one place to another.
- There was the problem of indivisibility in the case of such commodities as cattle.

2. Metallic money

With the spread of civilization and trade relations by land and sea, metallic money took the place of commodity money. Many nations started using silver, gold, copper, tin, etc. as money. But metal was an inconvenient thing to accept, weigh, divide and assess in quality. Accordingly, metal was made into coins of predetermined weight. This innovation is attributed to King Midas of Lydia in the eighth century B C. But gold coins were used in India many centuries earlier than in Lydia. Thus coins came to be accepted as convenient method of exchange.

As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This led governments to mix copper or silver in gold coins since their intrinsic value might be more than their face value. As gold became dearer and scarce, silver coins were used, first in their pure form and later on mixed with alloy or some other metal.

But metallic money had the following limitations.

(i) It was not possible to change its supply according to the requirements of the nation both for internal and external use.

(ii) Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another by merchants.

(iii) It was unsafe and inconvenient to carry precious metals for trade purposes over long distances.

(iv) Metallic money was very expensive because the use of coins led to their debasement and their minting and exchange at the mint cost a lot to the government.

3. Paper money

The development of paper money started with goldsmiths who kept strong safes to store their gold. As goldsmiths were thought to be honest merchants, people started keeping their gold with them for safe custody. In return, the goldsmiths gave the depositors a receipt promising to return the gold on demand. These receipts of the goldsmiths were given to the sellers of commodities by the buyers. Thus receipts of the goldsmith were a substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes.

The bank notes are issued by the central bank of the country. As the demand for gold and silver increased with the rise in their prices, the convertibility of bank notes into gold and silver was gradually given up during the beginning and after the First World War in all the countries of the world. Since then the bank money has ceased to be representative money and is simply ‘fiat money’ which is inconvertible and is accepted as money because it is backed by law.

4. Credit money

Another stage in the evolution of money in the modern world is the use of the cheque as money. The cheque is like a bank note in that it performs the same function. It is a means of transferring money or obligations from one person to another. But a cheque is different from a bank note. A cheque is made for a specific sum, and it expires with a single transaction. A cheque is not money. It is simply a written order to transfer money. However, large transactions are made through cheques these days and bank notes are used only for small transactions.

5. Near money

The final stage in the evolution of money has been the use of bills of exchange, treasury bills, bonds, debentures, savings certificates, etc. They are known as 'near money'. They are close substitutes for money and are liquid assets. Thus, in the final stage of its evolution money became intangible. Its' ownership in now transferable simply by book entry.

Definition of Money

It is very difficult to give a precise definition of money. Various authors have given different definition of money. According to Crowther, "Money can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value". Professor D H Robertson defines money as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations.

From the above two definitions of money two important things about money can be noted. Firstly, money has been defined in terms of the functions it performs. That is why some economists defined money as "money is what money does". It implies that money is anything which performs the functions of money. Secondly, an essential requirement of any kind of money is that it must be generally acceptable to every member of the society. Money has a value for 'A' only when he thinks that 'B' will accept it in exchange for the goods. And money is useful for 'B' only when he is confident that 'C' will accept it in settlement of debts. But the general acceptability is not the physical quality possessed by the good. General acceptability is a social phenomenon and is conferred upon a good when the society by law or convention adopts it as a medium of exchange.

Functions of Money

The major functions of money can be classified into three. They are: The primary functions, secondary functions and contingent functions.

I. Primary functions of money

The primary functions of money are;

- Medium of exchange and
- Measure of value

(i)Medium of exchange

The most important function of money is that it serves as a medium of exchange. In the barter economy commodities were exchanged for commodities. But it had experienced many difficulties with regard to the exchange of goods and services. To undertake exchange, barter economy required 'double coincidence of wants'. Money has removed this problem. Now a person A can sell his goods to B for money and then he can use that money to buy the goods he wants from others who have these goods. As long as money is generally acceptable, there will be no difficulty in the process of exchange. By serving a very convenient medium of exchange money has made possible the complex division of labour or specialization in the modern economic organization.

(ii) Measure of value

Another important function of money is that the money serves as a common measure of value or a unit of account. Under barter system there was no common measure of value and the value of different goods were measured and compared with each other. Money has solved this difficulty and serves as a yardstick for measuring the value of goods and services. As the value of all goods and services are measured in terms of money, their relative values can be easily compared.

II. Secondary functions

The secondary functions of money are;

(i) Standard of deferred payments

Another important function of money is that it serves as a standard for deferred payments. Deferred payments are those payments which are to be made in future. If a loan is taken today, it would be paid back after a period of time. The amount of loan is measured in terms of money and it is paid back in money. A large amount of credit transactions involving huge future payments are made daily. Money performs this function of standard of deferred payments because its value remains more or less stable. When the price changes the value of money also changes. For instance, when the prices are falling, value of money will rise. As a result, the creditors will gain in real terms and the debtors will lose. Conversely, when the prices are rising (or, value of money is falling) creditors will be the losers. Thus if the money is to serve as a fair and correct standard of deferred payments, its value must remain stable. Thus when there is severe inflation or deflation, money ceases to serve as a standard of deferred payments.

(ii)Store of value

Money acts as a store of value. Money being the most liquid of all assets is a convenient form in which to store wealth. Thus money is used to store wealth without causing deterioration or wastage. In the past gold was popular as a money material. Gold could be kept safely without deterioration.

Of course, there are other assets like houses, factories, bonds, shares, etc., in which wealth can be stored. But money performs as a different thing to store the value. Money being the most liquid of all assets has the advantage that an individual or a firm can buy with it anything at any time. But this is not the case with other assets. Other assets like buildings, shares, etc., have to be sold first and converted into money and only then they can be used to buy other things. Money would perform the store of value function properly if it remains stable in value.

In short, money has removed the difficulties of barter system, namely, lack of double coincidence of wants, lack of division and lack of measure and store of value and lack of a standard of deferred payment. It has facilitated trade and has made possible the complex division of labour and specialization of the modern economic system.

III. Contingent functions

The important contingent functions of money are;

(i) Basis of credit

It is with the development of money market the credit market began to flourish.

(ii) Distribution of national income

Being a common measure of value, money serves as the best medium to distribute the national income among the four factors of production.

(iii) Transfer of value

Money helps to transfer value from one place to another.

(iv) Medium of compensations

Accidents and carelessness cause damage to the property and life. Compensation can be paid to such damages in terms of money.

(v) Liquidity

Liquidity means the ready purchasing power or convertibility of money in to any commodity. Money is the most liquid form of all assets.

(vi) Money guide in production and consumption.

Utility of goods and services can be expressed in terms of money. Similarly, marginal productivity is measured in terms of prices of goods and factors. Thus money become the base of measurement and which directs the production and consumption.

(vii) Guarantor of solvency

Solvency refers to the ability to pay off debt. Persons and firms have to be solvent while doing the business. The deposits of money serves as the best guarantor of solvency.

Forms of money

Money of account

Money of account is the monetary unit in terms of which the accounts of a country are kept and transactions settled, ie., in which general purchasing power, debts and prices are expressed. The rupee is, for instance, our money of account. sterling is the money of account if Great Britain and mark that of Germany. Money of account need not, however, be actually circulating in the country. During 1922-24 the mark in Germany depreciated in such an extent that it ceased to be the money of account.

Limited and unlimited legal tender

Money which has legal sanction is called legal tender money. So its acceptance is compulsory. It is an offence to refuse to accept payment in legal tender money. Thus a legal tender currency is one in terms of which debts can be legally paid. *A currency is unlimited legal tender when debts upon any amount can be paid through it. It is limited legal tender when payments only up to a given limit can be made by means of it*. For example, rupee coins and rupee notes are unlimited legal tender in India. Any amount of transaction can be made by using them. But coins of lower amounts like 25 or 50 paisa are only limited legal tender (up to Rs.25/-). One can refuse to receive beyond this amount.

When a coin is worn out and become light beyond a certain limit, then it ceases to be a legal tender. When one rupee and half-rupee coins are more than 20% below the standard weight they are no longer legal tender.

Standard money

Standard money is one in which the value of goods as well as all other forms of money are measured. In India prices of all goods are measured in terms of rupees. Moreover, the other forms of money such as half-rupee notes, one rupee notes, two rupee notes, five rupee notes etc. are expressed in terms of rupees. Thus rupee is the standard money of India.

Standard money is always made the unlimited legal tender money. In old days the standard money was a ***full-bodied money***. That is its face value is equal to its intrinsic value (metal value). But now-a-days in almost all countries of the world, even the standard money is only a ***token money***. That is, the real worth of the material contained in it is very much less than the face value written in it.

Token money

Token money is a form of money in which the metallic value of which is much less than its real value (or face value). Rupees and all other coins in India are all token money.

Bank money

Demand deposits of banks are usually called bank money. Bank deposits are created when somebody deposits money with them. Banks also creates deposits when they advance loans to the businessmen and traders. These demand deposits are the important constituent of the money supply in the country.

It is important to note that bank deposits are generally divided into two categories: demand deposits and time deposits. Demand deposits are those deposits which are payable on demand through cheques and without any serving prior notice to the banks. On the other hand, time deposits are those deposits which have a fixed term of maturity and are not withdrawable on demand and also cheques cannot be drawn on them. Clearly, it is only demand deposits which serve as a medium of exchange, for they can be transferred from one person to another through drawing a cheque on them as and when desired by them. However, since time or fixed deposits can be withdrawn by forgoing some interest and can be used for making payments, they are included in the concept of broad money, generally called M3.

Demand for money

Why people have demand for money to hold is an important issue in macroeconomics. The level of demand for money not only determines the rate of interest but also the level of prices and national income of the economy. The demand for money arises from two important functions of money. The first is that money acts as a medium of exchange and the second is that it is a store of value. Thus individuals and businesses wish to hold money partly in cash and partly in the form of assets.

What determines the changes in demand for money is a major issue. There are two views. The first is the 'scale' view which is related to the impact of the income or wealth levels upon the demand for money. The demand for money is directly related to the income level. The higher the income level, the greater will be the demand for money.

The second is the 'substitution' view which is related to relative attractiveness of assets that can be substituted for money. According to this view, when alternative assets like bonds become unattractive due to fall in interest rates, people prefer to keep their assets in cash, and the demand for money increases, and vice versa. The scale and substitution view combined together have been used to explain the nature of the demand for money which has been split into the transactions demand, the precautionary demand and the speculative demand.

Classical economists considered money as simply a means of payment or medium of exchange. In the classical model, people, therefore, demand money in order to make payments for their purchases of goods and services. In other words, they want to keep money for transaction purposes.

On the other hand J M Keynes also laid stress on the store of value function of money. According to him, money is an asset and people want to hold it so as to take advantage of changes in the price of this asset, that is, the rate of interest. Therefore Keynes emphasized another motive for holding money which he called speculative motive. Under speculative motive, people demand to hold money balances to take advantage from the future changes in the rate of interest or what means the same thing from the future changes in bond prices.

An essential point to be noted about people's demand for money is that what people want is not 'nominal money' holdings, but 'real money balances'. This means that people are interested in the purchasing power of their money balances, that is, the value of money balances In terms of goods and services which they could buy. Thus people would not be interested in merely nominal money holdings irrespective of the price level, that is, the number of rupee notes and the bank deposits. If with the doubling of price level, nominal money holdings are also doubled, their real money balances would remain the same. If people are merely concerned with nominal money holdings irrespective of price level, they are said to suffer from 'money illusion'.

The demand for money has been a subject of lively debate in economics because of the fact that monetary demand plays an important role in the determination of the price level, interest and income. Till recently, there were three approaches to demand for money, namely, transaction approach of Fisher, cash balance approach of Cambridge economics, Marshall and Pigou and Keynes theory of demand for money. However, in recent years, Baumol, Tobin and Friedman have put forward new theories of demand for money.

The Supply of Money

The supply of money is a stock at a particular point of time, though it conveys the idea of a flow over time. The supply of money at any moment is the total amount of money in the economy.

There are three alternative views regarding the definitions or measures of money supply. The most common view is associated with the traditional and Keynesian thinking which stresses the medium of exchange function of money. According to this view, money supply is defined as currency with the public and demand deposits with the commercial banks. Demand deposits are savings and current accounts of depositors in a commercial bank. They are the liquid form of money because depositors can draw cheques for any amount lying in their accounts and the bank has to make immediate payment on demand. Demand deposits with the commercial bank plus currency with the public are together denoted as M_1, the money supply. This is regarded as the narrower definition of the money supply.

The second definition is broader and is associated with the modern quantity theorists headed by Friedman. Prof. Friedman defines the money supply at any moment of time as "literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credit at banks or dollars they have to their credit at banks in the form of demand deposits, and also commercial bank time deposits". Time deposits are fixed deposits of customers in a commercial bank. Such deposits earn a fixed rate of interest varying with the time period for which the amount is deposited. Money can be withdrawn before the expiry of that period by paying a penal rate of interest to the bank. So time deposits posse liquidity and are included in the money supply by Friedman. Thus the definition includes M_1 plus time deposits of commercial banks in the supply of money. This wider definition is termed as M_2 in America and M_3 in Britain and India. It stresses the store of value function of money.

The third function is the broadest and is associated with Gurley and Shaw. They include in the money supply, M_2 plus deposits of saving banks, building societies, loan associations, and deposits of other credit and financial institutions.

Measures of Money Supply in India

There are four measures of money supply in India which are denoted by M_1, M_2, M_3, and M_4. This classification was introduced by Reserve Bank of India (RBI) in April, 1977. Prior to this till March, 1968, the RBI published only one measure of money supply, M or M_1 which is defined as currency and demand deposits with the public. This was in keeping with the traditional and Keynesian views of the narrow measure of money supply.

From April, 1968 the RBI also started publishing another measure of the money supply which is called Aggregate Monetary Resources (AMR). This included M_1 plus time deposits of banks held by the public. This was a broad measure of money supply which was in line with Friedman's view.

Since April, 1977, the RBI has been publishing data on four measures of the money supply which are cited below;

1) **M_1** – The first measure of money supply M_1 consists of:

- Currency with the public which includes notes and coins of all denominations in circulation excluding cash in hand with banks;
- Demand deposits with commercial and co-operative banks, excluding inter-bank deposits; and

- 'Other deposits' with RBI which include current deposits of foreign central banks, financial institutions and quasi-financial institutions such as IDBI, IFCI, etc. RBI characterizes M_1 as narrow money.

2) **M_2** – The second measure of money supply M_2 consists of M_1 plus post office savings bank deposits. Since savings bank deposits commercial and co-operative banks are included in the money supply, it is essential to include post office saving bank deposits. The majority of people in rural and urban have preference or post office deposits from the safety viewpoint than bank deposits.

3) **M_3** – The third measure of money supply in India M_3 consists of M_1 plus time deposits with commercial and cooperative banks, excluding interbank time deposits. The RBI calls M_3 as broad money.

4) **M_4** – The fourth measure of money supply M_4 consists of M_3 plus total post office deposits comprising time deposits and demand deposits as well. This is the broadest measure of money supply.

Of the four inter-related money supply for which the RBI publishes data, it is M3 which is of special significance. It is M_3 which is taken into account in formulating macroeconomic objectives of the economy every year.

FISHER'S QUANTITY THEORY OF MONEY: THE CASH TRANSACTIONS APPROACH

The Quantity Theory of Money states that the quantity of money is the main determinant of the price level or the value of money. Any change in the quantity of money produces an exactly proportionate change in the price level. According to Fisher, "other things remaining the same, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa". If the quantity of money doubled, the price level also double and the value of money will be one half. On the other hand, if the quantity of money is reduced by one half, the price level will also be reduced by one half and the value of money will be twice.

Fisher has explained his theory in terms of his equation of exchange:

MV = PT

Where, M=the quantity of money in circulation V = transactions velocity of circulation P

= average price level.

T = the total number of transactions.

According to Fisher, the nominal quantity of money M is fixed by the Central Bank of the country and is therefore treated as an exogenous variable which is assumed to be given quantity in a particular period of time. Further, the number of transactions in a period is a function of national income; the greater the national income, the larger the number of transactions required to be made. Since Fisher assumed full-employment of resources prevailed in the economy, the volume of transactions T is fixed in the short run.

Fischer extended the equation by including the credit money. That is; PT **= MV + M^IV^I**

Where, M^I = total quantity of credit money

V^I = the velocity of circulation of credit money

This equation equates the demand for money (PT) to the supply of money ($MV + M^IV^I$). The total volume transactions multiplied by the price level represents the demand for money. According to Fischer, PT = ∑PQ. In other words, price level (P) multiplied by quantity bought (Q) by the community (∑) gives the total demand for money. This equals the total supply of money in the community consisting of the quantity of total money M and its velocity of circulation V plus the quantity of credit money M^I and its velocity of circulation V^I. Thus total value of purchases (PT) in a year is measured by $MV + M^IV^I$. Thus equation of exchange is $PT = MV + M^IV^I$. In order to find out the effect of the quantity of money on the price level, or the value of money, we write the equation as;

$$P = \frac{MV + MIVI}{T}$$

Fisher points out that the price level (P) varies directly with the quantity of money ($M+M^I$), provided the volume of trade (T) and velocity of circulation (V, V^I) remain unchanged. This implies that if M and M^I doubled, while V, V^I and T remain constant, P is also doubled, but the value of money (1/P) is reduced to half.

Criticisms of the theory

Fischer's quantity theory of money has been subjected to the following criticisms.

1. **Truism.** According to Keynes, "the quantity theory of money is a truism". Because, it states that the total quantity of money paid for goods and services ($MV + M^IV^I$) must equals

their value (PT). But it cannot be accepted today that a certain percentage change in the quantity of money leads to the same percentage change in the price level.

2. **Other things not equal.** The assumption of 'other things remaining the same' is not real. In real life, V, V^I and T are not constant. Moreover, they are not independent of M, M^I and P.

3. **Constants relate to different time.** Prof. Halm criticizes Fisher for multiplying M and V because M relates to a point of time and V to a period of time. The former is a static concept ant the latter is a dynamic concept. Therefore, it is technically inconsistent to multiply these two non-comparable factors.

4. **Fails to measure value of money.** Fisher's equation does not measure the purchasing power of money but only cash transactions, that is, the volume of business transactions of all kinds or what Fisher calls the volume of trade in the community during a year. But value of money relates to transactions for the purchase of goods and services for consumption. Thus the theory fails to measure the value of money.

5. **Weak theory.** According to Crowther, the quantity theory is weak in many respects. First, it cannot explain 'why' there are fluctuations in the price level in the short run. Second, it gives undue importance to the price level as if changes in prices were the most critical and important phenomenon of the economic system. Third, it places a misleading emphasis on the quantity of money as the principal cause of changes in the price level during the trade cycle. Prices may not rise despite increase in the quantity of money during depression; and they may not decline with reduction in the quantity of money during boom. Further, low prices during depression are not caused by shortage of quantity of money, and high prices during prosperity are not caused by abundance of quantity of money.

Neglects interest rate. One of the main weaknesses of Fisher's quantity theory on money is that it neglects the role of the rate of interest as one of the causative factors between money and prices. Fisher's equation of exchange is related to an equilibrium situation in which rate of interest is independent of the quantity of money.

INFLATION AND DEFLATION

I. Meaning of Inflation

Inflation is a highly controversial term. By inflation we mean a general rise in prices. More precisely, inflation is a persistent rise in the general price level rather than a once-for-all rise in it. It was first defined by neo-classical economists. They meant by it a galloping rise in prices as a result of the excessive increase in the quantity of money.

To the neo-classical and their followers at the University of Chicago, inflation is fundamentally a monetary phenomenon. In the words of Friedman, "*Inflation is always and everywhere a monetary phenomenon and can be produced only by a morse rapid increase in the quantity of money than output*". Coulborn defines inflation as "too much money chasing too few goods." But many economists do not agree that money supply alone is the cause of inflation. As pointed out by Hicks, 'Our present troubles are not of a monetary character'. Economists, therefore, define inflation in terms of a continuous rise in prices. Johnson defines "inflation as a sustained rise in prices". Brooman defines it as "a continuing increase in the general price level". According to Crowther, inflation is a "state in which the value of money is falling, ie. the prices are rising."

Types of Inflation

Inflation is of various types. We can discuss some of its important types.

1. Creeping Inflation.

When the rise in prices is very slow like that of a snail or creeper, it is called creeping inflation. In terms of speed, a sustained rise in prices of annual increase of less than 3 percent per annum is characterized as creeping inflation. Such an increase in prices is regarded as safe and essential for growth.

2. Walking or Trotting Inflation

When prices rise moderately and the annual inflation rate is a single digit such an inflation is called walking inflation. In other words, the rate of rise in prices is in the intermediate range of 3 to 6 per cent per annum or less than 10 per cent. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.

3. Running Inflation

When prices rise rapidly like the running of a horse at a rate or speed of 10 to 20 per cent per annum, it is called running inflation. Such an inflation affects the poor and middle classes adversely. Its control requires strong monetary and fiscal measures, otherwise, it leads to hyper- inflation.

4. Hyper Inflation

When prices rise very fast at double or triple digit rates from more than 20 to 100 per cent per annum or more, it is usually called ‘runway or galloping inflation. It is also characterized as hyperinflation. In reality, hyperinflation is a situation when the rate of inflation becomes immeasurable and absolutely uncontrollable. Prices rise many times every day. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.

5. Semi-inflation

According to Keynes, so long as there is unemployed resources the general price level would not rise as output increases. But a large increase in aggregate expenditure will face shortages of supplies of some factors which may not be substitutable. This may lead to increase in costs, and prices starts rising. This is known as semi-inflation or bottleneck inflation because of the bottlenecks in the supplies of some factors.

6. True inflation

According to Keynes, when the economy reaches the level of full employment, any increase in aggregate expenditure will lead to rise in the price level in the same proportion. This is because it is not possible to increase the supply of factors of production and hence of output after the level of full employment. This is called true inflation.

7. Open inflation

Inflation is open when ‘markets for goods or factors of production are allowed to function freely, setting prices of goods and factors without normal interference by the authorities.’ Thus open inflation is as a result of uninterrupted operation of the market mechanism. There are no controls on the distribution of commodities by the government. Unchecked open inflation may leads to hyper inflation.

8. Suppressed inflation

When the government imposes physical and monetary controls to check inflation, it is known as suppressed or repressed inflation. The market mechanism is not allowed to function normally by the use of licensing, price controls and rationing in order to suppress the expensive rise in prices. So long as such controls exist, the present demand is postponed and there is diversion of demand from controlled to uncontrolled commodities.

9. Stagflation

Stagflation is a new term which has been added to economic literature in the 1970s. It is a paradoxical phenomenon where the economy experiences stagnation as well as inflation. The word stagflation is the combination of ‘stag’ plus ‘flation’ taking ‘stag’ from stagnation and ‘flation’ from inflation. Stagflation is a situation when recession is accompanied by a high rate of inflation. It is, therefore, also called inflationary recession. The principal cause of this phenomenon has been excessive demand in the commodity markets thereby causing prices to rise, and at the same time the demand for labour is deficient thereby creating unemployment in the economy.

Three factors responsible for the existence of stagflation in the advanced countries since, 1970 are;

a. rise in oil prices and other commodity prices along with adverse changes in the terms of trade;
b. the steady and sustained growth of the labour force; and c) rigidities in the wage structure due to strong trade unions.

10. Mark-up inflation

The concept of mark-up inflation is closely related to the price-push problem. Modern labour organizations possess substantial monopoly power. They, therefore, set prices and wages on the basis of mark up over costs and relative incomes. Firms possessing monopoly power have control over the prices charged by them. So they have administered prices which increase their profit margin. This leads to an inflationary rise in prices.

11. Ratchet inflation

A ratchet is a toothed wheel provided with a catch that prevents the ratchet wheel from moving backward. The same is the case under ratchet inflation when despite downward pressures in the economy, prices do not fall. In an economy when aggregate demand falls below full employment level due to the deficiency of demand in some sectors of the economy the price level do not fall. It is because the wage, cost and price structure are inflexible downward. Large business firms and labour organizations possess monopoly power. Consequently, the fall in the demand may not lower prices significantly. In such a situation prices will have an upward ratchet effect and this is termed as “ratchet inflation”.

12. Sectoral inflation

Sectoral inflation arises when there is excess demand in certain sectors. It leads to a rise in prices in other sectors also.

13. Reflation

It is a situation when prices are raised deliberately in order to encourage economic activity. When the economy phases depression the monetary authority adopts measures to put more money in circulation. This leads to rise in prices which is called as ‘reflation’

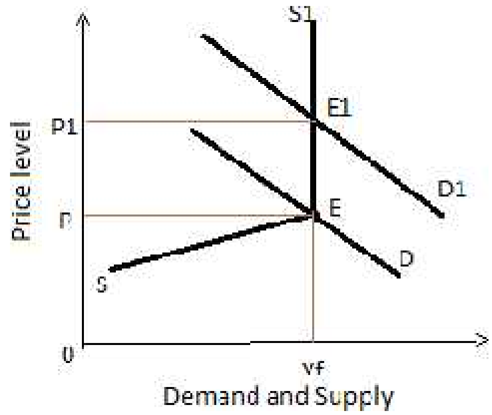
Inflation can also be classified into two broad categories: demand-pull inflation and cost push inflation.

1. DEMAND PULL INFLATION

Demand pull inflation is a situation where price rises due to the excess demand in the economy. In this sense, inflation is defined as “too much money chasing too few goods”. In other words, an excess of aggregate demand over aggregate supply causes inflationary rise in prices in the economy. This can be explained easily with the quantity theory of money. The theory states that prices rise in proportion to the increase in money supply. Given the full employment level of output, doubling the money supply will double the price level. So inflation proceeds at the same rate at which the money supply expands. In this analysis the aggregate supply is assumed to be fixed and there is always full employment in the economy.

Modern quantity theorists led by Friedman hold that “inflation is always and everywhere a monetary phenomenon.” The higher the growth rate of the nominal money supply, the higher is the rate of inflation. When the money supply increases, people spend more in relation to the available supply of goods and services. This bids prices up. Modern quantity theorists neither assume full employment as a normal situation nor a stable velocity of money. Still they regard inflation as a result of increase in the money supply.

The demand pull inflation is illustrated in the following figure.



Suppose the economy is initially in full employment equilibrium at the point E. At this point equilibrium price is determined by the intersection of demand and supply curves D and SS1 respectively. Now with the increase in the quantity of money, the aggregate demand increases. As a result the demand curve shifts to the right to D1.Since the aggregate supply is fixed which is shown by the vertical portion of the supply curve SS1, the demand curve D1 intersects it at the point E1. This raises the price level to OP1.

The Keynesian theory on demand-pull inflation is based on the argument that, so long as there are unemployed resources in the economy, an increase in investment expenditure will lead to increase in employment, income and output. Once full employment is reached and bottlenecks appear, further increase in expenditure will lead to excess demand because output ceases to rise, thereby leading to inflation.

2. COST PUSH INFLATION

Cost push inflation is caused by rise in the cost of production – that is, rise in wages, price of raw materials or profits.

a) Rise in wages

The basic cause of cost-push inflation is the rise in the money wages more rapidly than the productivity of labour. In advanced countries, the trade unions are very powerful. They press the employers to raise the wages. This leads to increase in cost of production of commodities. Employers, in turn, raise the prices of their products. Higher wages enable the workers to buy as much as before, in spite of higher prices. On the other hand, the increase in prices induces trade unions to demand still higher wages. In this way, the wage-cost spiral continues, thereby leading to cost-push or wage-push inflation.

b) Sectoral rise in prices

A few sectors of the economy may be affected by money wage increases and prices of their products may be rising. In many cases, these products may be used as inputs by other sectors. As a result, production costs of other sectors will rise and thereby pushes the prices of their products.

Thus wage-push inflation in a few sectors of the economy may soon lead to inflationary rise in prices in the entire economy.

c) Rise in prices of imported raw materials

An increase in the prices of imported raw materials may lead to cost-push inflation. Since raw materials are used as inputs by the manufactures of the finished goods, they enter into the cost of production of the latter. Thus a continuous rise in the prices of raw materials tends to sets off a cost-push inflation.

d) Profit-push inflation

Monopolist and Oligopolist firms raise the prices of their products to offset the rise in labour and production costs so as to earn higher profits. Profit-pull inflation is, therefore, also called administered price theory of inflation or price-push inflation or sellers’ inflation or market-power inflation.

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COMMERCIAL BANKING

With the introduction and use of money credit also came into existence. Credit is created when one party (a person, a firm or an institution) lends money to another party, the borrower. The act of lending and borrowing creates both credit and debit. Whereas debt means the obligation to pay the finance borrowed, credit means the claim to receive this money payment from the other party.

The act of borrowing and lending and thereby creation of credit is a special type of exchange transaction which involves future payment of the principal sum borrowed as well as the rate of interest on it. In the modern times there are a variety of institutions which specialize in borrowing and lending of money. The bank credit is only one form of credit. Money lenders, indigenous bankers, credit co-operative societies, commercial and co-operative banks, industrial financial institutions, LIC, export finance houses, etc. are all credit institutions and do the borrowing and lending money.

A bank is an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances.

A commercial bank is a business organization which deals money; it borrows and lends money. In this process of borrowing and lending of money it makes profit. The distinction between money lender and a commercial bank may be noted. Whereas a money lender only lends money to others and that too from his own sources, a commercial bank does both the lending and borrowing business. A commercial bank raises its resources through borrowing from the public in the form of deposits and lends them to the businessmen. Its lending rate of interest is greater than that it pays to its depositors. It is because of this difference in lending and borrowing rates of interest that it is able to make profit.

Functions of Commercial Banks

Commercial banks perform a variety of functions. They can be categorized as accepting deposits, advancing loans, credit creation, agency functions and miscellaneous functions.

1. Accepting deposits

The banks borrow in the form of deposits. This function is important because banks mainly depend on the funds deposited with them by the public. The deposits received by the banks can be of three types;

a) Demand or current account deposits: In this type of deposits the depositor can withdraw the money in part or in full at any time he likes without notice. These accounts are generally kept by the businessmen whose requirements of making business payments are quite uncertain. Usually, no interest is paid on them, because the bank cannot utilize these short term deposits and must keep almost cent percent reserve against them. But in return for these current account deposits, the banks offer some facilities or concession to the account holders. The most important is the cheque facility made available to them. Further, on behalf of the current account deposits, bank collects cheques, drafts, dividend warrants, postal orders, etc.

b) Fixed deposits or time deposits: These deposits are made for a fixed period of time, which varies from fifteen days to a few years. These deposits cannot, therefore, be withdrawn before the expiry of that period. However, a loan can be taken from the bank against the security of this deposit within that period. A higher rate of interest is paid on the fixed deposits based on the period of the deposits.

c) Saving bank deposits: In this case the depositor can withdraw money usually once a week. These deposits are generally made by the people of small means, usually people with fixed salaries, for holding short-term savings. Like the current account deposits, the saving bank deposits are payable on demand and also they can be drawn upon through cheques. But in order to discourage people to use the saving bank deposits very frequently, there are some restrictions on the number of times withdrawals can be made from these accounts. The saving deposits carry lower rate of interest than the fixed deposits.

2. Advancing loans

One of the primary functions of the commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. Thus the bank earns profits and carries on its business.

The bank advances loans in the following ways:

a) Cash credit: The bank advances loan to businessmen against certain specified securities. The amount of loan is credited to the current account of the borrower. In the case of a new customer a loan account for the sum is opened. The borrower can withdraw money through cheques according to his requirements but pays interest on the full amount.

b) Call loans : These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first class bill or securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

c) Overdraft: A bank often permits a businessman to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessmen. But he is charged interest only on the amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the bank.

d) Discounting bills of exchange: If a creditor holding a bill of exchange wants money immediately, the bank provides money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill holder after deducting the rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

3. Credit creation

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping a small amount of cash as reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of customer and does not pay him in cash but allows him to draw the money by cheques according to his needs. By granting a loan, the bank creates credit or deposit.

4. Financing Foreign Trade

A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and sells foreign currency.

5. Investment

It is obligatory for commercial banks to invest a part of their funds in approved securities. Other optional avenues of investments are also available. Investments in government securities are useful in two ways. One is that, the commercial banks can get income from their surplus funds. The other is that the liquidity, that is, encashability of securities is higher than that of loans.

6. Agency Services

Commercial bands act as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premium, rent, electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these service, the bank charges a nominal fee while it renders others free of charge.

7. Miscellaneous Services

Besides the above noted services, the commercial bank performs a number of other services. It acts as a custodian of the valuables of its customers by providing them lockers where they can keep their jewellery and valuable documents. it issues various forms of credit instruments, such as cheques, drafts, travellers' cheques, etc. which facilitate transactions. The bank also issues letters of credit and acts as a referee to its clients. It underwrites shares and debentures of companies and helps in the collection of funds from the public. ATM stands for Automated Teller Machine. It is also depicted as Any Time Money as it provides the customers to withdraw money 24 hours subject to certain restrictions.

CENTRAL BANK

In the monetary system of all countries, the central bank occupies an important place. The central bank is the apex bank in a country. It is called by different names in different countries. It is the Reserve Bank of India in India (set up in 1935), the Bank of England in England, the Federal Reserve System in America, the Bank of France in France, etc.

Functions of a Central Bank

The following are the major functions of a central bank.

1. Note Issuing Agency

The central bank of the country has the monopoly of issuing notes or paper currency to the public. Therefore, the central bank of the country exercises control over the supply of currency in the country. In India with the exception of one rupee notes which are issued by the Ministry of Finance of the Government of India, the entire note is done by the Reserve Bank of India.

Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank. This system is operative in India whereby the Reserve Bank of India is required to keep Rs.115 crores in gold and Rs. 85 crores in foreign securities. There is no limit to issue of notes after keeping this minimum amount of Rs 200 crores in gold and foreign securities.

2. Banker to the Government

The central bank acts as a banker, agent and adviser to the government. It keeps the banking accounts of the government. All the balances of the government are kept with the central bank. But it pays no interest on these balances. Further, the central bank has to manage the public debt and also to arrange for the issue of new loans on behalf of the government. The central bank also provides short-term loans to the government. Thus it manages the public debt and advises the government on banking and financial matters.

3. Control of credit

The chief objective of the central bank is to maintain price and economic stability. For controlling inflationary and deflationary pressures in the economy the central bank adopts quantitative and qualitative measures of credit control. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action.

4. Bankers' bank

The central bank acts as a bankers' bank in three capacities:

(a) as the custodian of the cash reserves of the commercial banks;

(b) as the lender of the last resort; and

(c) as bank of central clearance, settlement and transfers.

All other banks in the country are found by law to keep a fixed portion of their total deposits as reserves with the central bank. These reserves help the central bank to control the issue of credit by commercial banks. They in return can depend up on the central bank for support at the time of emergency. This help may be in the form of a loan on the strength of approved securities or through rediscounting of bills of exchange. Thus the central bank is the lender of last resort for other banks in difficult times.

In India, scheduled banks have to keep deposits with the Reserve Bank not less than 5% of their current demand deposits and 2% of their fixed deposits as reserves. In return they enjoy the privilege of rediscounting their bills with the Reserve Bank as well as securing loans against approved securities when needed.

Clearing function is also performed by the central bank for the banks. Since banks keep cash reserves with the central bank, settlement between them may be easily effected by means of debts and credits in the books of the central bank. If clearing go heavily against some bank, its cash reserves with the central bank will fall below the prescribed limit and therefore the bank concerned will have to make up the deficiency.

5. Lender of the last resort

The central bank helps the commercial banks when they face any difficulty. Even a well managed commercial bank can run into difficulty if there is a great rush of demand for cash by the depositors. During such occasions it will not be able to meet a sudden and large demand for cash. The central bank must therefore come to their rescue at such times. Thus the central bank is the last source of supply of credit.

6. Custody and Management of Foreign Exchange Reserves

The central bank keeps and manages the foreign exchange reserves of the country. An important function of a central bank is to maintain the exchange rate of the national currency. For example, the Reserve Bank of India has the responsibility of maintaining the exchange value of the rupee. When a country has adopted flexible exchange rate system under which value of a currency is determined by the demand for and supply of a currency, the value of a currency, that is, its exchange rate with other currencies is subject to large fluctuations which are harmful for the economy. Under these circumstances, it is the duty of the central bank to prevent undue depreciation or appreciation of the national currency. Since 1991 when the rupee has been floated, the value of Indian rupee, that is, its exchange rate with US dollar and other foreign currencies has been left to be determined by market forces. RBI has been taking several steps from time to time to stabilize the exchange rate of rupee, especially, in terms of US dollar.

There are several ways by which RBI can manage or maintain the exchange rate of the rupee.

(i) If due to speculative activities of foreign exchange operators, the rupee starts depreciating fastly, RBI can intervene in the market. It can use its reserves of dollars and supply dollars in the market from its own reserves. With the increase in the supply of dollars, the rupee will be prevented from depreciation. It may however be noted that the success of this step depends on the amounts of dollar reserves with RBI.

(ii) Another method by which RBI can manage the exchange rate of rupee is adopting measures which will reduce the demand for dollars. Some importers, foreign investors, foreign exchange operators try to avail of cheap credit facilities of banks and borrow rupee funds from the banks and try to convert them into dollars. This raises the demand for dollars and leads to the depreciation of the Indian rupee. Such a situation occurred in July-September, 1998. RBI intervened and raised the Cash Reserve Ratio

(CRR) and increased its repurchase rates. This succeeded in mopping up the excess liquidity with the banks and reduced their lending capacity. This led to the reduction in the demand for dollars and helped in preventing the rupee from depreciating.

MONETARY POLICY

Monetary policy is an important instrument of economic policy to achieve multiple objectives. *Monetary policy is concerned with the measures taken to regulate the supply of money, the cost and availability of credit in the economy*. It also deals with the distribution of credit between uses and users and also with both the lending and borrowing rates of interest of the banks. In developed countries the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy. However, in developing countries it has to play a significant role in promoting economic growth.

It is important to understand the distinction between goals, targets and instruments of monetary policy. Whereas goals of monetary policy refer to the objectives such as price stability, full employment or economic growth, targets refer to the variables such as supply of money or bank credit, interest rates which are sought to be changed through the instruments of monetary policy so as to attain these objectives. The various instruments of monetary policy are changes in the supply of currency, variations in bank rates and other interest rates, open market operations, selective credit controls and variations in reserve requirements.

Instruments of Monetary Policy

The various instruments of monetary policy are;

1. Bank rate policy
2. Open market operations
3. Variable reserve ratio
4. Selective credit controls

1. Bank Rate Policy

Bank rate or rediscount rate is the rate fixed by the central bank at which it rediscounts the first class bills of exchange and government securities held by the commercial banks. The bank rate is the interest rate charged by the central bank at which it provides rediscount to banks. The central bank controls credit by making variations in the bank rate. When the economy needs to expand credit (during the periods of deficient demand), the central bank lowers the bank rate. Then borrowing from central bank becomes cheap. So the commercial banks will borrow more. They will, in turn, advance loans to customers at a lower rate. The market rate of interest will be reduced. This encourages business activity. The opposite happens when credit to be contracted in the economy. The central bank raises the bank rate when the economy phases excess demand which makes borrowing costly from it. So the banks borrow less. They, in turn, raise their lending rates to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans. This leads to contraction of credit which depresses the rise in prices. Thus lowering the bank rate offsets deflationary tendencies and raising the bank rate controls inflation.

2. Open Market Operation

Open market operations are another quantitative method of credit control. This method refers to the sale and purchase of securities, bills and bonds of government and private financial institutions by the central bank.

There are two principal of open market operations. One, it influence the reserves of commercial banks in order to control their power of credit creation. Two, to affect the market rates of interest so as to control the commercial bank credit. In this method of credit control, when the central bank of a country wants to control expansion of credit by commercial banks for the purpose of controlling inflationary pressures within the country, it sells government securities in the money market. The purchasing power in the economy is reduced to the extent the commercial banks and individuals purchase government securities.

On the other hand, when the central bank aims at an expansionary policy during a recessionary period, it purchases government securities from the commercial banks and institutions dealing with such securities. The central bank pays the sellers of its cheques drawn against itself which are deposited into their accounts with the commercial banks. The reserves of the latter increase with the central bank which are just like cash. As a result the supply of bank money increases.

Another impact of the open market policy is that when the supply of money changes as a result of open market operations, the market rates of interest also change. A decrease in the supply of bank money through the sale of securities will have the effect of raising the market interest rates. Similarly, an increase in the supply of bank money through purchase of securities will reduce the market interest rates. Thus open market operations have a direct influence on the market rates of interest also.

3. Variable Reserve Ratio

Variable reserve ratio (or required reserve ratio or legal minimum requirements) as a method of credit control was first suggested by Keynes in his Treatise on Money(1930) and was adopted by the Federal Reserve System of the United States in 1935.

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. It may be either a percentage of its time and demand deposits separately or of total deposits. Whenever the amount of money remains with the commercial banks over and above these minimum reserves is known as the 'excess reserves.' It is on the basis of these excess reserves that the commercial bank is able to create credit. The larger the size of excess reserves, the greater is the power of a bank to create credit. and vice versa.

Changes in cash reserve ratio is a powerful method for influencing not only the volume of excess reserves with the commercial banks but also the credit multiplier of the banking system. A change in reserve requirements affect the money supply in two ways: (a) it changes the level of excess reserves; and (b) it changes the credit multiplier

Suppose the commercial bank keep 10% of their central bank. This means Rs.10 of reserves would be required to support Rs.100 of deposit and the credit multiplier is 10 (ie. 1/10% = 10). To check inflation, the central bank raises the cash reserve ratio from 10% to 12%. As a result, the commercial banks will have to maintain a greater cash reserve of Rs.12 instead of Rs.10 for every deposit of Rs.100 and they will now decrease their lending by 2%. The credit multiplier will fall from 10 to 8.3 (ie. 1/12% = 8.3). On the other hand, to check deflation, the central bank may reduce the cash reserve ratio from 10% to 8% and thus make available 2% excess reserve to commercial banks which they utilize to expand credit. The credit multiplier will then rise from 10 to 12.5 (ie. 1/8% = 12.5).

4. Selective Credit Controls

Selective or qualitative methods of credit control are meant to regulate and control the supply of credit among its possible users and uses. They are different from quantitative or general methods which aim at controlling the cost and quantity of credit. The aim of selective credit control is to channelize the flow of bank credit from speculative and other undesirable purposes to socially desirable and economically useful uses. They also restrict the demand for money by lying down certain conditions for borrowers. The main types of selective credit controls generally used by the central banks in different countries are cited below:

a) Regulation of Margin Requirements

This method is employed to prevent excessive use of credit to purchase or carry securities by speculators. The central bank fixes minimum margin requirements on loans for purchasing or carrying securities. Control over margin requirements means control over down payments that must be made in buying securities on credit. The margin requirement is the difference between the market value of the security and its maximum loan value. If a security has a market value of Rs.100 and if the marginal requirement is 60% the maximum loan that can be advanced for the purchase of security Rs.40. Similarly, a marginal requirement of 80% would allow borrowing of only 20% of the price of the security and a marginal requirement of 100% means that the purchasers of securities must pay the whole price in cash. Thus an increase in marginal requirements will reduce the amount that can be borrowed for the purchase of a security.

b) Regulation of Consumer Credit

Under the consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash. The balance is financed through the bank credit which is repayable by the consumer in installments. The central bank can control the consumer credit by (a)changing the amount that can be borrowed for the purchase of the consumer durables and (b)changing the maximum period over which the installments can be extended.

c) Rationing of Credit

Rationing of credit may assume two forms: (i) the central bank may fix its rediscounting facilities for any particular bank; (ii) the central bank may fix the minimum ratio regarding the capital of a commercial bank to its total assets. In other words, credit rationing aims at (1) limiting the maximum loans and advances to the commercial banks, and (2) fixing ceiling for specific categories of loans and advances.

d) Moral Suasion

Moral suasion means advising, requesting and persuading the commercial banks to cooperate with the central bank in implementing with its monetary policy. Through this method, the central bank merely uses its moral influence to make the commercial bank to follow its policies. For instance, the central bank may request the commercial banks not to grant loans for speculative purposes. Similarly, the central bank may persuade the commercial banks not to approach it for financial accommodation. This method is a psychological method and its effectiveness depends upon the immediate and favorable response from the commercial banks.

e) Publicity

The central banks also use publicity as a method of credit control. Through publicity, the central bank seeks : (i) to influence the credit policies of the commercial banks; (ii) to educate people regarding the economic and monetary condition of the country; and (iii) to influence the public opinion in favour of its monetary policy.

f) Direct Action

The method of direct action is most extensively used by the central bank to enforce both quantitative as well as qualitative credit controls. This method is not use in isolation; it is often used to supplement other methods of credit controls. Direct action refers to the directions issued by the central bank to the commercial banks regarding their lending and investment policies. It may take different forms: (i) the central bank may refuse to discounts the bills of exchange of the commercial banks whose credit policy is not in line with the general monetary policy of the central bank. (ii) the central bank may charge a penal rate of interest, over and above the bank rate, on the money demanded by the bank beyond the prescribed limit (c) the central bank may refuse to grant more credit to the banks whose borrowings are found to be in excess of their capital and reserves.

MODULE II
PUBLIC FINANCE

Introduction

Public finance deals with the finances of public bodies – national, State or Local – for the performance of their functions. The performance of these functions leads to expenditure. The expenditure is incurred from funds raised through taxes, Fees, Sale of goods and services and loans. The different sources constitute the revenue of the public authorities. Public finance studies the manner in which revenue is raised; the expenditure is incurred upon different items etc… Thus public finance deals with the income and expenditure of public authorities and principles, problems and policies relating to these matters.

Definitions

"For all States – whether crude or highly developed – some provisions of the kind are necessary and there for supply and application of state resources constitute the subject matter of a study which is best entitled in English as Public Finance" – Charles F. Bastable ("Public Finance – 1892)

"One of those subjects which lie on the border line between Economics and Politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one to the other" – Prof. Hugh – Dalton – ("Principles of Public Finance- 1922). The term 'Public authorities' refers to the Government or State – all levels –National, State and Local.

"A field of enquiry that treats the income and out goes of governments –federal, state and local"- Harold Groves. This definition outlines the types of governments whose finances are studied in Public finance.

"Public Finance is the fiscal science, its policies are fiscal policies, its problems are fiscal problems" –Taylor. According to him public finance studies the manner in which the state through its organ, the government, raises and spends the resources required. Public Finance is thus concerned with the operation and policies of the fisc - The State treasury.

"The main content of Public Finance consists of the examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants and secure the necessary funds to carry out this purpose" – Mrs. Ursula Hicks. This definition of Public Finance highlights the satisfaction of collective wants which in turn leads to the need to secure necessary resources.

"The discipline of Public Finance describes and analyses the government services, subsides and welfare payments and methods by which the expenditure to these ends are covered through taxation, borrowing, foreign aid and creation of new money" –CS Shoup. This definition enlarges the scope of Public Finance for modern governments to include different types of expenditure and different sources of revenue.

All the definitions started above illustrate the scope of Public Finance. From these definitions, we can conclude that Public Fiancé is and enquiry into the facts, techniques, principles, theories, rules and policies which shape, direct, influence and govern the use of scarce resources, with alternative uses, of the governments.

The subject matters of Public Finance can be broadly classifieds in to five categories –

a) Public revenue b) Public expenditure c) Public debt d) Financial administration e) Economic stabilization and f) Federal Finance.

Public Revenue;

The income of the states is referred to as Public Revenue in this branch, we study the various ways of raising revenue by the public bodies. We also study the principles and effects of taxation and how the burden of taxation is shared among the various classes of society.

Public Expenditure

It deals with the principles and problems relating to the allocation of public spending. We study the fundamental principles governing the flow of public funds in to different channels, classification and justification of Public Expenditure; expenditure policies of governments and the measures adopted for welfare state.

Public Debts;

The governments borrow when its revenue falls shot of its expenditure Public debts is a study of various principles and methods of raising debts and their economic effects. It also deals with the methods of repayments and managements of public debts.

Financial Administration;

In deals with the methods of Budget preparation, various types of Budgets, war Finance, Development Finance etc… thus, Financial administration refers to the mechanism by which the financial functions are carried on. In other words, financial administration studies the organizing and disbursing of the finances of the State.

Economic stabilization and Growth

The use of Public revenue and Public expenditure to secure stability in levels of prices by controlling inflationary as well as deflationary pressures is studied. Similarly the income and expenditure policies adopted by the government so as to attain full employment, Optimum use of resources, equitable distribution of income etc.. are also studied.

Public Finance and Private Finance

The understanding and the study of public finance is facilitated by a comparison of the public or government finance with private or individual finance. Such a comparison will help us to know how the aims and objectives and methods of public Finance operation are similar or differed from the financial operations of the individual.

Similarities

1. Both the State as well as individual aim at the satisfaction of human wants through their financial operations. The individuals spend their income to satisfy their personal wants where as the state spends for the satisfaction of communal or social wants.
2. Both the States and Individual at times have to depend on borrowing , When their expenditures are greater than incomes
3. Both Public Finance and Private Finance have income and expenditure. The ultimate aim of both is to balance their income and expenditure.

4. Both kinds of Finances, the guiding principle is rationality. Rationality in the sense that maximization of personal benefits and social benefits through corresponding expenditure.
5. Both are concerned with the problem of economic choice, that is, they right to satisfy unlimited ends with scarce resources having alternative uses.

Dissimilarities

1. The private individual has to adjust his expenditure to his income. ie, his expenditure is being determined by his income. But on the other hand the government first deter minds its expenditure and the devices ways and means to raise the necessary revenue to meat the expenditure.

2. The government has large sources of revenue than private individuals. Thus at the time of financial difficulties the state can raise internal loans from its citizens as well as external loans form foreign countries. In the case of private individual, all borrowings are external in nature.

3. The state, when hard pressed, can resort to printing of currency, as an additional source of revenue. In fact, during emergencies like war, it meats its increased financial obligations by printing new currency. But an individual cannot raise income by creating money.

4. The state prep ears its budget or estimate its income and expenditure annually. But there is no such limitation for an individual. It may be for weekly, monthly, or annually.

5. A surplus budget is always good for a private individual. But surplus budgets may not be good for the government. It implies two things.

a) The government is levying more taxes on the people than is necessary and The government is not spending as much as the welfare of the people as it should.

6. The individual and state also differ in their motives regarding expenditure. The individuals hanker after profit. Their business operations are guided by private profit motive. But the states expenditure is guided by the welfare motive.

7. The private individual spends his income on various items in such a manner as to secure equi

– marginal utilities from them. The government on the contrary does not give as much importance to this law as a private individual does. Modern government some times incur cretin types of expenditure from which their do not derive any advantage but they do inker this expenditure to satisfy cretin sections of the community.

8. Individuals always seek quick returns they save only a small amount for future and spend more to satisfy their current needs. Individual tent to think more or present as they are dead in the long run similarly they seldom spend if it does not yield any money income. On the other hand, State has a long term perspective of its expenditure. It does not care only for immediate benefit. State spends on projects having long gestation period. The burden of taxation is borne by the present generation in the interest of long run welfare of the community. Similarly some times government may have to spend on schemes which may not yield any money income at all (e.g. Public Health)

9. An individual's spending policy has very little impact on the society as a whole. But the state can change the nature of an economy through its fiscal policies.

10. The pattern of expenditure in the case of private finance is often influence by customs, habits social status etc… The pattern of government expenditures is guided by the general economic policy followed by the government.

11. Private Finance is always a secret affair. Individual need not reveal their financial transactions to any one except for filing tax returns. But Public Finance is an open affair. Government budget is widely discussed in the parliament and out sides. Public accountability is an important future of public finance.

12. Individuals can plan to postpone their private expenditure. But the state cannot afford to put off vital expenditure like defense , famine relief etc… Findlay Shiraz says that compulsory character is an important future of public finance.

THE PRINCIPLE OF MAXIMUM SOCIAL ADVANTAGE

One of the important principles of public finance is the so – call principle of maximum social advantage explain by Professor Hugh Dalton. Just like an individual seeks to maximize his satisfaction or welfare by the use of his resources, the state ought to maximize social advantage or benefit from the resources at its command.

The principles of maximum social advantage are applied to determine whether the tax or the expenditure has proved to be of the optimum benefit. Hence, the principle is called the principle of public finance. According to Dalton, “This (Principle) lies at the very root of public finance”

He again says “The best system of public Finance is that which secures the maximum social advantage from the operations which it conducts”. t may all so called the principle of maximum social benefit . A.C. Pigou has called it the principle of maximum aggregate welfare.

Public expenditure creates utility for those people on whom the amount is spent. When the volume of expenditure is small with a slighter increase in it, the additional utility is very high. As the total public expenditure goes on increasing in course of time, the law of diminishing marginal utility operates. People derive less of satisfaction from additional unit of public expenditure as the government spends more and more. I.e. after a stage, every increase in public expenditure creates less and less benefit for the people. Taxation, on the other hand, imposes burden on the people. So, when the volume of taxation becomes high , every further increase in taxation increases the burden of it more and more . People under go greater scarifies for every additional unit of taxation. The best policy of the government is to balance both sides of fiscal operations by comparing “the burden of tax” and “the benefits of public expenditure” The State should balance the social burden of taxation and social benefits of Public expenditure there would be maximum social advantage.

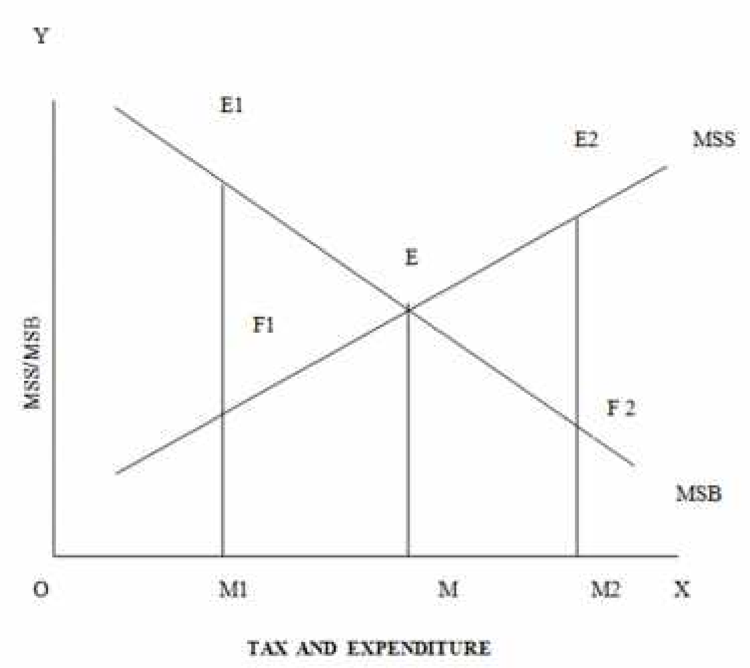
Attainment of maximum social advantage requires that;

a) Both public expenditure and taxation should be carried out up to certain limits and no more.

b) Public expenditure should be utilized among the various uses in an optimum manner, and

c) The different sources of taxation should be so tapped that the aggregate scarifies entailed is the minimum

Diagrammatic Representation



The curves MSS and MSB show the marginal social scarifies of taxation and marginal social benefit of public expenditure respectively. MSS curve slopes up words since taxation increases marginal social sacrifices. MSB curves slopes down wards showing that public benefit goes on declining with every increase in public expenditure. The ideal point of financial operations is where the governments collect OM taxation from the society and uses it for public expenditure. At this point , MSS is exactly equal to MSB (Point E) at OM 1 , MSS is M1 F1 which is less than MSB (M1 , E1) the depicting a loss of welfare to the society (E1 F1). Similarly is the government is collecting OM 2 taxation to finance larger public expenditure, The MSS is higher than MSB by E2 F2. So the ideal level of taxation and expenditure is at OM. According to Dalton "Public expenditure in every direction, should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding increase in taxation or in receipts from any other source of public income. This gives the ideal public expenditure and income".

PUBLIC REVENUE

The income of government through all sources is known as public revenue or public income.

Prof. Dalton defined public revenue in two senses –

Narrow sense and be a broader sense. In the narrow sense, it includes income from taxes prices of goods and services supplied by public sector under takings, revenue from administrative activities, such as fees fine etc. In the wider sense, it includes all the incomes of the governments during a given period of time, including public borrowing from individuals and banks and income from public enterprise it is known as public receipts.

SOURCES OF PUBLIC REVENUE

The sources of public revenue can be broadly classified in to two – Tax source and non tax source.

Taxes: Taxes are imposed by the government on the people and it is compulsory on the part of the citizens to pay taxes, without expecting a return.

Some definitions:

a) by Prof. Seligman: "Tax is compulsory contribution from a person to the government to defray the expenses incurred in the common interests of all without reference to special benefits conferred".

b) By Prof. Taylor "Taxes are compulsory payments to the governments without expectation of direct return to or benefit to the tax payer"

c) By Prof. Bastable"Tax is compulsory contribution of the wealth of a person for the service of public power".

d) By Prof. Taussig " The essence of a tax , as distinguished from other charges by government , is the absence of a direct quid pro quo between the tax payer and the public authority"

The revenue from taxes came from three main sources. viz; a) Taxes on income b) Taxes on wealth and property and c) Taxes on commodities

Characteristics of a Tax

1. It is compulsory payments to the government from the citizen
2. It is imposes a personal obligation. it means that it is duty of tax payer to pay it and he should in no case think to evade it.

3. Absence of direct benefit or quid pro quo between the State and people.
4. It is payments for meeting the expenses in the common interest of all citizens.
5. Certain taxes are imposed on specific objectives for example, tax on petrol to reduce consumption and tax on luxuries so as to divert resources for the production of essential commodities.
6. There is no tax without representation.

Non - Tax Revenue

a) Commercial Revenue. (Income from public property and enterprises)
b) Administrative Revenue (Fee, Fine, Special assessment)
c) Gifts and grants and
d) Others

Commercial Revenue:

Income earned by public enterprises by selling their goods and services. For example, Payments for postage, tolls, interest on borrowed funds etc.. They are also known as prices because they come in the form of prices and goods and services provided by government.

Administrative Revenue

The receipts of incomes accrued on account of performing administrative functions by the government are called administrative revenue. The important items of administrative revenue are listed below.

Fees: "Fee is a payments to defray the cost of each recurring service under taken by the government in the public interest" – Prof. Seligman. Fees are a payment imposed by the government. For Example, Court Fee, License Fee, Passport, Fee etc.

Fines and Penalties – Fines penalties are imposed on persons as a punishment for infringement of laws. They are imposed to prevent crime. Fines and penalties are arbitrarily determined.

Special assessments: - according to Prof. Seligman "A special assessment is a compulsory contribution levied in proportion to the special benefit derived to defray the cost of specific improvement to property under taken in the public interest". For example, when the government constructs a highway, the prices of plots on either side of it will naturally go up. There for, the land owners may be required to bear a part of expenses incurred by the government. Such charges are called as special assessments.

Gifts and grants: - In general gifts and grants are the payments maid by one government to another for some specific functions for example, central grant to state government. Gifts are voluntary contribution maid by the people to the government for some special purposes.

Other sources of Revenue: - other sources of revenue are Forfeitures, Escheat, Issues of currency and Borrowings

Forfeitures: - it is penalty imposed by the court for failure of individual to appear in the court to complete certain contract as stipulated.

Escheat: - Properties having no legal heirs or without will, that go to government are called Escheats.

Issue of Currency: - The printing of proper money yields income to the government it is mean to create extra resources by the printing of paper money. It is normally avoided because if once this method of financing is started it becomes difficult to stop it. This further leads to inflation.

Borrowings: - This is another source of public revenue. That is through borrowings from the public in the shape of deposits bonds etc. It also includes

Classification Taxation

Taxes are classified on different bases. Different bases adopted by the economists to classified taxes are the forms, nature, aims and methods of taxation. The various taxes may be classified under following major heads.

Public Expenditure

The expenses incurred by the govt. for its own maintenance, preservation and welfare of the economy as a whole is referred to as public expenditure. In other words, it referred to the expenses of public authorities-central, state and local govt. in a federation-for the satisfaction of collective needs of the citizens or for promotion of economic and social welfare. The development functions include education, public health, social security, irrigation, canal, drainage, roads, buildings, etc. The major cause of increase in the public expenditure is nothing but, these developmental functions. Hence, the study of public expenditure has become very significant in the study of public finance.

The two major reasons for the same are: a) the economic activities of the state has increased manifold and b) nature and volume of public expenditure have greatly affected the economic life of the country in a different manner. ie, it has affected production and distribution and general level of economic activities.

In the laissez-faire era the state was assigned a very limited role to play. The functions assigned to the state where based on the principle of least interference or ‘that govt is the best which spends the least.’ According to the classicals lead by Adam Smith restricted the functions of the state to ‘Justice, Police and Arms.’ They considered govt. expenditure wasteful and that money could be used much better by private persons than by the govt. Adam Smith in his magnum opus ‘The Wealth of Nations’ published in 1776 observed that the sovereign has three main duties to perform as a) to protect the society from violence and invasion of other independent societies b) to protect against injustice and c) erecting and maintaining certain public works.

According to David Ricardo, ‘if you want a peaceful govt. you must reduce the budget’. JB Say opined that ‘the very system of all plans of finance is to spend little and the best of all taxes is that which is least in amount.

In recent time, public expenditure has been increased enormously. The main reason is the functions of govt. have increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, a German economist presented his famous ‘Law of Increase of State Activities’ he states that ‘comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local govts.’ This increase is both intensive and extensive. The central and local govts. Constantly undertake new functions, while they perform both, old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a satisfactory fashion are satisfied by the central and local govts. Prof. RA Musgrave, the twentieth century economist, advocated public expenditure since a govt. is forced to do many activities such as 1) activities to secure a reallocation of resources 2) redistribution activities, 3) stabilizing activities and 4) commercial activities.

Causes for the Increase in Public Expenditure:

One of the most important features of the present century is the phenomenal growth of public expenditure. Some of the important reasons for the growth of public expenditure are the following.

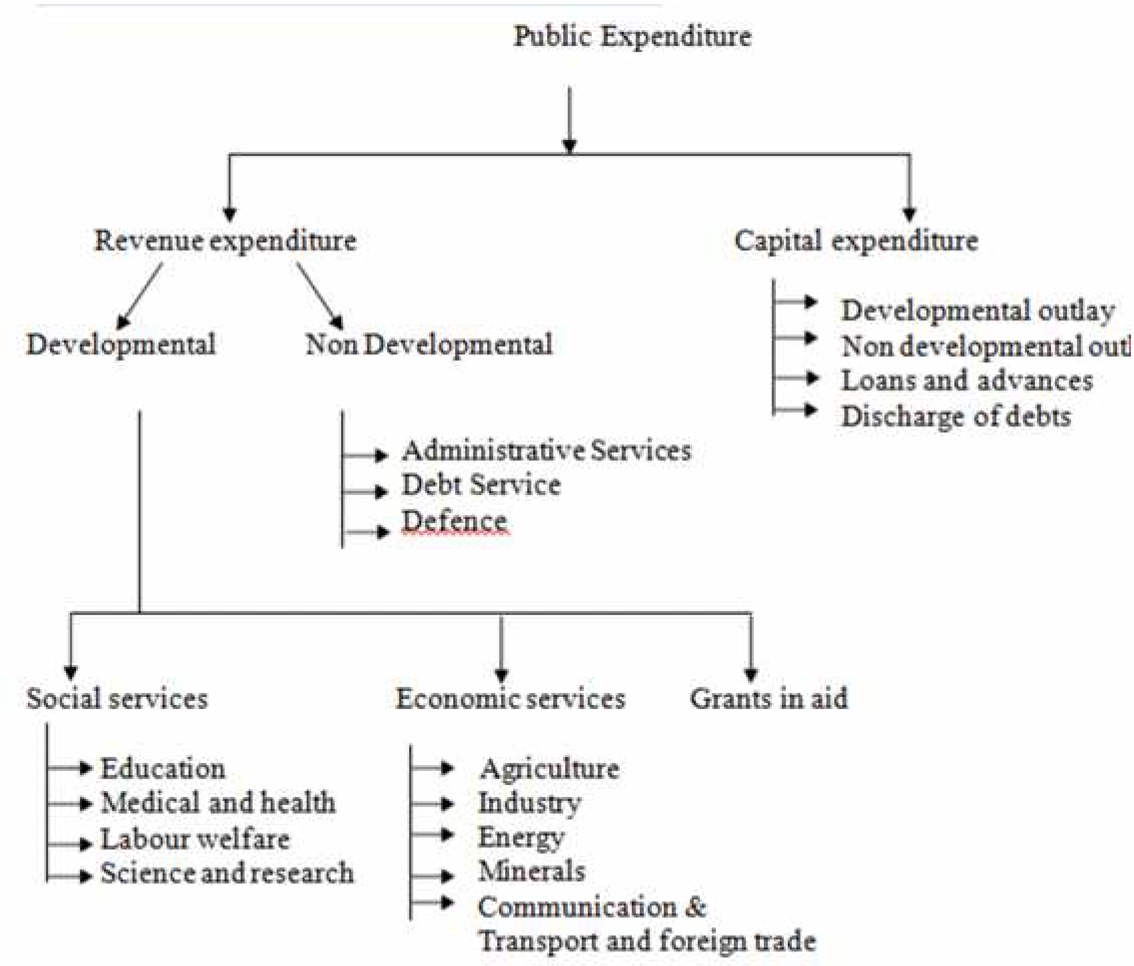
1) Welfare state: Modern states are no more police states. They have to look in to the welfare of the masses for which the state has to perform a no. of functions. They have to create and undertake employment opportunities, social security measures and other welfare activities. All these require enormous expenditure.
2) Defence expenditure: Modern warfare is very expensive. Wars and possibilities of wars have forced the nation to be always equipped with arms. This causes great amount of public expenditure.
3) Growth of democracy: the form of democratic govt. is highly expensive. The conduct of elections, maintenance of democratic institutions like legislatures cause great expenditure.
4) Growth of population: tremendous growth of population necessitates enormous spending on the part of the modern govts. For meeting the needs of the growing population more educational institutions, food materials, hospitals, roads and other amenities of life are to be provided.
5) Rise in price level: Rises in prices have considerably enhanced public expenditure in recent years. Higher prices mean higher spending on the part of the govt. on items like payment of salaries, purchase of goods and services and so on.
6) Expansion public sector: Counties aiming at socialistic pattern of society have to give more importance to public sector. Consequent development of public sector enhances public expenditure.
7) Development expenditure: for implementing developmental programs like Five Year Plans, Modern govts are incurring huge expenditure.
8) Public debt: Along with debt rises the problem like payment of interest and repayment of the principal amount. This results in an increase in public expenditure.

9) Grants and loans to state govts and UTs: It is an important feature of public expenditure of the central govt of India. The govt provides assistance in the forms of grants-in-aid and loans to the states and to the UTs ;

10) Poverty alleviation programs: as poverty ratio is high, huge amount of expenditure is required for implementing allegation programs.

Classification of public expenditure:

Public expenditure has been classified in to a) Revenue expenditure and b) Capital expenditure. Revenue expenditure is current expenditure. For example, administrative and maintenance. This expenditure is of a recurring type. Capital expenditure of capital nature and is incurred once for all. It is non-recurring expenditure. For example, expenditure in building, multi- purpose projects or on setting up big factories like steel plants, money spent on land, machinery and equipment. This can be explained as follows:



Theories of growth of public expenditure.

As we know in modern times all the countries of the world have witnessed an enormous increase in public expenditure. The three important theories of the growth public expenditure are the following:

1) Adolph Wagner's hypothesis
2) Wiseman – Peacock hypothesis and
3) Colin Clark's Critical limit hypothesis.

Adolph Wagner's Hypothesis: Adolph Wagner believed that there was a cause-effect relationship between economic growth and public expenditure. His hypothesis of Law of Increasing State Activity lays that as a percapita income and output increase in industrialized counties, the public expenditure of those counties necessarily grows as a proportion to total economic activity. He explained that 'comprehensive comparisons of different countries and different times shows that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both central and local govts. The increasing both extensive and intensive, the central and local govts. Constantly undertake new functions, while they perform both old and new functions more effectively and completely.'

Conclusions:-

1) As the national income increases in amount, the percentage of outlay for govt. supplied goods is greater.
2) Increased public expenditure was the natural result of economic growth and continued pressure for social progress.

Wiseman – Peacock hypothesis: According to Wiseman and Peacock Public Expenditure does not increase in a smooth and continuous manner. The increasing public expenditure over time has occurred in step-like manner. The general approach to the hypothesis refers to the three related concepts.

1) Displacement effect 2) Inspection effect and 3) concentration effect.

The movement from older level of expenditure and taxation to a new and higher level is called the displacement effect.

War and other social disturbances force the people and govts. to find solutions of important problems, which had been neglected earlier. This is called the inspection effect. That is, new obligations imposed on state, in the form of increased debt interest and war pensions etc.

The concentration effect refers to the apparent tendency for the central govt. economic activities to become an increasing proportion of the total public sector economic activity when the society is experiencing economic growth.

Critical Limit Hypothesis: (Colin Clark): The hypothesis was developed by Colin Clark immediately after the Second World War. It is concerned with the tolerance level of taxation. By maximum limit of the tolerance level is 25% of GNP. When the share of govt. expenditure exceeds 25% in the GNP, inflation occurs even in balanced budget.

Public Debt

Among the non-tax sources, the major source of revenue of the government is public debt. That is, borrowing. It may either be internal or external debts. When the government raises revenue by borrowing from within the country, it is called internal debt. Similarly, if the government is borrowing from the rest of the world, it is a case of external debt. According to Philip E. Taylor, "The debt is the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on the principal. Borrowing is resorted to provide funds for financing a current deficit."

Causes for Public Debt

Till the beginning of the 20th century, state performed only limited functions- maintenance of law and order, protection of the country from external attack etc. Therefore, the state had to collect only small revenue and little. Recently, in almost all countries of the world there has been a great increase in the magnitude and variety of governmental activities. The acceptance of the principle of the welfare state increases the role of state participation in economic activity. This has necessitated the need to find out additional sources of finance. Hence, modern governments have come to rely on public borrowings.

Objectives of public debt:

The objectives of public debt are the following.

1)To bridge the budget deficit (Deficit Financing)

To fight against depression.

2) To check inflation.

3) To finance economic development.

4) To meet unforeseen contingencies.

5) An alternate source of income when taxable capacity is reached.

6) To finance wars.

7) To finance public enterprises.

8) To carry out welfare programmes.

9) To create infrastructure.

10) For creation of productive assets.

11) For creation of essential non-income yielding assets(provision of public goods) etc.

Important Sources of Public Debt

Every government has two major sources of borrowing—internal and external. Internally the government can borrow from individuals, financial institutions, commercial banks and the central bank. Externally, the governments borrow from individuals and banks, international institutions and foreign governments. They can be briefly summarized as follows.

1) Borrowing from individuals.
2) Borrowing from Non-Banking Financial Institutions.(Insurance companies, investment trusts, mutual funds etc,)
3) Borrowing from commercial banks.
4) Borrowing from central banks.
5) Borrowing from External sources(IMF,IBRD,ADB, Foreign Governments| countries)

Classification of Public Debt

1) Voluntary and compulsory (On the basis of legal enhancement): Voluntary debt is the debt which is paid any legal enforcement. Where as compulsory debt is legally forced in nature. Here people have no option but repay the debt.

2) Funded and unfunded debt (Provision for repayment): funded debt is long term or ‘definite period’ debt. A proper agreement and terms and conditions of repayment with the percentage of interest payable is declared. They are used for creation of permanent assets. Un funded debt is for a short term and for indefinite period. It is paid through the income received from other sources. These are used for meeting current needs.

3) Internal and external debt: When the government raises revenue by borrowing from with in the country, it is call internal debt. Where as if the government is borrowing from the rest of the world, it is case of external debt.

4) Productive and unproductive (Purpose of loans) Loans on Projects yielding income (Construction of plants, railways, power schemes etc.) are called productive debt. Loans on loan non income yielding projects are called unproductive loans (war, famine relief etc)

5) Redeemable and irredeemable loans (Promise to repay) Redeemable debts refers to the loan which the government promises to pay off at some future date. (principal plus interest) Irredeemable debts are those, principal amount of which are never returned by the government but payees interest regularly.

6) Shot / Medium/ Long term loans (Time duration): Short term loans are usually incurred for a period varying from three months to one year. Usually governments get such loans from the central bank by using treasury bills. These loans are calls ‘ways and means advances’

Medium Term loans are those which are obtain for more than one year but less than ten years.

Long term loans are those which are obtain for more than tern years. These are used to finance developmental activities.

Deficit Financing

Mc. Graw Hill dictionary of modern economics define deficit financing “as a practice by government of spending more than what receives in revenue. Those a government is said to be practicing deficit Financing when it spends in excess of its current revenue”.

According to the Planning Commission of India “Deficit Financing is used to denote the direct addition to Gross National Expenditure through budget deficit whether the deficit are on the revenue account or capital account. The essence of such a policy lies there for in government spending in excess of the revenue it receipts in the shape of taxes earning of state enterprises, loan from public deposits and funds and other miscellaneous sources. The government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system”.

In Indian context deficit financing takes place; when a budgetary deficit financed by using any one of the following methods.

a) The government may with draw its cash balances from the central bank or
b) Government may borrow fund from the central bank or
c) Government may resort to printing of additional currency

Advantage of deficit financing

1. Best use of resources.
2. Helpful to developing countries difficult to create resources through taxation .
3. Additional purchasing power.
4. Helpful despite inflationary nature.

Limitations

1. Raise in prices
2. Increase in money supply
3. Speculative activities
4. Adverse effect on savings.
5. Less investment.
6. Unequal distribution of income and wealth.

Fiscal Policy

According to Arthur Smithies Fiscal policies is “A policy under which the government uses its expenditure and revenue programes to produce desirable effect and avoid undesirable effect on the national income, production and employment”.

Fiscal policy is

a) Budgetary policy of the government;
b) It uses public expenditure and taxation as instruments ; and
c) Its objectives is to influence production and employment favorably

The significance of fiscal policy was first emphasized by J.M. Keynes, in mid 1930 s in his "General Theory of Employment, Interest and Money" published in 1936.

Fiscal policy refers to the policy of government with relation to taxation, public expenditure and management of public debt. In other words fiscal policy refers to the financial activities under taken to correct either inflation or deflation.

The classical concept of fiscal policy

The classical believed in laissez – Faire, Say's law of market, full employment, optimum allocation of resources etc. According to them full employment is a common phenomenon and is supposed to reach automatically. There is no necessity of any governmental interference. The concept of fiscal policy held by the classical is known as 'Principal of sound finance" according to them "That government is the best which spends the least and imposes lowest amount of taxes".

Modern concept of fiscal policy

The modern concept of fiscal policy is called "Functional Finance". This was first stated by J.M.Keynes and was developed by Abba P. Lerner. According to the policy of functional Finance "Government has to play a positive roll so as to regulate and control the economy by means of taxes and expenditure".

Objectives of fiscal policy in developed countries

1. Full employment
2. Price stability
3. High and stable rate of growth

Objectives of fiscal policy in less developed centuries

1. Full employment
2. Price stability
3. Accelerated rate of economic development
4. Optimum allocation of resources
5. Equitable distribution income and wealth
6. Economics stability and
7. Capital formation and growth

Finance Commission

Under the provisions of the constitution, the president is required under Article 280 (1) to constitute within two years from the commencement of the constitution and there after the expiration of every fifth year or at such early year time as he may consider necessary. The commission is charged with the tremendous responsibilities of making requisite recommendation to the president of India. The Finance Commission consists of a chairman and four members to be appointed by the president.

Functions of Finance Commission

There are two important functions – Suggestive functions and making recommendations – to be performed by the Finance Commission.

Suggestive Functions

1. To suggest the criteria of distribution between union and States of net proceeds which are to be or may be divided between them.
2. It deter minds the allocation of net proceeds between different states according to their respective shares of proceeds.
3. Any modification continuance of the term of any agreement entered in to by the union government with the government of any State in part B of the First schedule under clause (v) of Article 178 or Article 306
4. The principal which should govern the grants – in –aid of the revenue of defence state out of the consolidated fund of India.
5. Any other matter refers to the commission by the President of India.

Making Recommendations

1. The percentage of net proceeds of the Taxes which may be divided between center and State.
2. The allocation of Shares of the proceeds of such taxes in percentages between different States.
3. To deter mind the principal to govern the grants – in aid of the revenue out of the consolidated fund of government of India between States.
4. The modification of continuances of the term of agreement regarding the levy of International customs and duties with part B States.
5. Grants in aids in tribal areas and
6. Special grants for any particular state.

MODULE-III

TRADE

Internal and External trade

Internal or domestic trade can be defined as exchange of goods and services amoung the residents of the same country. It refers to the trade within the geographical territory of a country. It is the trade between different regions within the same country or the domestic exchanges which takes place within the country

On the other hand, external or international trade may be defined as exchange of goods and services between the residents of a given country and those of the rest of the world. Thus, international trade takes place between the two countries. The main differences between the internal and international trade are as follows

1) Factor Mobility

The factors of production, notably labour and capital resources, are more mobile within the country. If the internal mobility were perfect there would not exist interregional differences in factor prices. The factors would move away from the regions where their prices are relatively lower towards the regions where their prices are relatively higher, until the factor price differences are completely wiped off. It is on account of greater mobility of labour and capital within the country that there is a tendency for the equalisation of wage rates and interest rates.

However, in the international setting, the factor mobility is neither free nor perfect. There are restrictive immigration laws which prevent free mobility of labour form one country to another. In respect of capital, there are restrictions on the inflow and outflow of capital and investment across national frontiers. In addition to these legal barriers, there are several other barriers like differences in language, climate, social customs and practices, political and educational systems etc which create additional barriers to factor mobility between countries. Thus, due to comparatively less mobility of labour and capital, the production costs of the same commodity become different in two countries. It is on account of the differences in production costs that international trade takes place.

2) Product Mobility

Within the country, the movement of goods and services from one region to another is free. The only internal barriers to free movement of goods and services are the distance and cost of transportation (natural barriers). As against this, there are formidable man-made and natural barriers on trade between two countries. Besides import and export tariffs, exchange controls and other non-tariff barriers put obstacles to the free movement of goods and services between one country and the other. From this point, international trade is quite different from internal trade in goods and services.

3) Economic Environment

Within the country, the economic environment is more or less same in all regions of the country. The government policy with regard to interest rates, taxes, wages or prices are the same within the country. Similarly, market structures and consumer taste patterns and preferences are more or less the same throughout the country. But between countries they could all differ very significantly. This would make the character of international trade significantly different for that of international trade.

1) Monetary Units

Usually a single currency unit is used throughout the entire country. There is only one currency is used as a medium of exchange or a measure of value which would make the exchange very smooth as far as internal trade is concerned. But there are different currencies in different countries. The differences with the currency systems prevailing in different countries considerably hamper the smooth flow of goods and services between countries. Thus a number of foreign exchange difficulties arise in international trade.

2) Natural Advantages

There can be differences in natural resources and the geographical conditions of different countries. Availability of certain natural resources, geographical and climatic conditions etc give natural advantages to some countries. These advantages lead to territorial division of labour and localization of industries. These advantages cannot be transferred from one country to another.

Why international trade?

Since the publication of *Wealth of Nations,* economists have sought answers to a number of questions concerning international trade theory such as why do countries trade with one another?

.For more than two hundred years economist have tried to convince the public and policy makers that countries trade for the same reason individuals trade. Countries like individuals are not equally capable of producing every good or service they want and need to consume. All countries like individuals can benefit if each country specialises in producing those goods it can produce best and satisfy their other wants and needs by trading with other countries. Specialization and trade makes total world output of goods and services larger than it would be without trade. In international trade all countries gain and are better-off than the alternative, that is buying and selling goods restricted to their domestic markets. In the words of Horn and Gomez “international trade benefit to all participating nations and injury to none”

Historically, trade has been an important mainspring of growth of countries at different stages of development. In the 19th century the countries that were industrializing has access to food and raw materials in the primary producing countries which allowed the more developed countries to reap the gains from international specialization. In turn, the developing countries were assisted in their development by the demand for raw materials. But today most trade takes place in industrial commodities in which many poor countries find it difficult to compete and demand for developing country’s traditional export is slack relative to demand for industrial goods. Except for a very few commodity booms, trade does not seem to work to the equal advantage of both sets of countries. The problem facing developing countries is not so much *whether to trade* but *in what commodities* to trade and to ensure that the terms on which they trade with developed countries are favorable.

During the 19th century, most of the world’s industrial production was concentrated in England. Large increase in industrial production and population in resource-poor England led to rapidly rising demand for food and raw material exports of the ‘regions of recent settlements’ such as the United States, Canada, Australia, New Zealand etc. The stimulus provided by their rapidly expanding exports then spread to rest of the economy of these new settled lands. According to R Nurkse, the export sector was the leading sector that propelled these economies into rapid growth and development. That is, international trade functioned as an "*engine of growth*" for these countries during the 19th century.

The regions of recent settlement were able to satisfy England's growing demand for food and raw materials because of several circumstances. Firstly, these countries were richly endowed with natural resources such as fertile land, forests and mineral deposits. Secondly, workers with various skills moved in large numbers from overpopulated Europe to these mostly empty lands, and so did huge amounts of capital. The huge inflows of capital and workers made possible the construction of roads, rails, canals and other facilities that allowed the opening up of new supply sources of food and raw materials. Finally, great improvement on sea transportation enabled these new lands to satisfy rising demand for food and raw materials more cheaply than traditional sources supply in Europe and elsewhere. But there are economists such as Kravis who believe that the rapid growth of the regions of recent settlements during the 19th century was primarily due to very favorable internal conditions, with trade playing only an important supportive role.

It is generally agreed that today's developing countries can relay much less on trade for their growth and development. This is due to less favorable demand and supply conditions. *On the demand side,* it is pointed out that the demand for food and raw materials is growing much less rapidly today than the case for the regions of recent settlement during the 19th century. Main reasons are

(1) The income elasticity of demand in developed countries for many of the food and raw materials exports of developing countries is less than one, so that as income rises in developed countries, their demand for exports of developing countries increases proportionately less than the increase in income.

(2) The development of synthetic substitutes has reduced the demand for natural raw materials

(3) Technological advances have reduced the raw material content of many products

(4) The output of services (with lower raw material requirement than commodities) has

grown faster in developed countries

(5) Developed countries have imposed trade restrictions on many exports of developing countries like wheat, vegetables, sugar, oils and other products

On the supply side, it is pointed out that most of today's developing countries are much less endowed with natural resources than were the regions of recent settlements during the 19^{th} century. Again, most of the developing countries are overpopulated, so that most of any increase in their output of food and raw materials is absorbed domestically rather than exported. Furthermore, the international flow of capital to most developing courtiers today is relatively much less than it was for the regions of recent settlements during the 19^{th} century and today's developing countries seem also to face an outflow of skilled labour rather than an inflow. Finally, it is said that until recently, developing countries have somewhat neglected their agriculture in favour of more rapid industrialization, thereby hampering their export and development prospects.

Thus, even though international trade, in general, cannot to be an engine of growth today, there are still ways in which it can contribute to the economic growth of today's developing countries. Haberler has pointed out the following important beneficial effects that the international trade can have on economic development:

1. Trade can lead to the full utilization of otherwise unemployed domestic resources. That is through trade, a developing country can move from an inefficient production point inside its production frontier to a point on its production frontier with trade. For such a country, trade would represent a '*vent for surplus*' or an outlet for its potential surplus of agricultural commodities and raw materials.
2. By expanding size of the market, trade make possible division of labour and economies of scale
3. International trade is the vehicle for the transmission of new ideas, new technology and new managerial and other skills.
4. Trade also stimulates and facilitates the international flow of capital from developed to the developing countries
5. In several large developing countries, the importation of new manufactured

products has stimulated domestic demand until efficient domestic production of these goods become feasible and

6. International trade is an excellent antimonopoly weapon because it stimulates greater efficiency by domestic producers to meet foreign competition

Balance of Trade

According to James E Meade balance of trade is the difference between the value of goods and services sold to foreigners by the residents and firms of the home country and the value of goods and services purchased by them from foreigners. In other words, the difference between the value of goods and services exported and imported by a country is the measure of balance of trade.

If the two sums, that is, the value of exports of goods and services and the value of imports of goods and services are exactly equal to each other, we say that there is balance of trade equilibrium. If the former exceeds the latter, we say that there is balance of trade surplus and if the latter exceeds the former we describe the situation as balance of trade deficit. Balance of trade surplus is regarded as favorable and balance of trade deficit is regarded as unfavorable. In the familiar macroeconomic equation $Y = C+I+G+(X-M)$, the expression for net exports X-M denotes balance of trade in Meade's sense.

However, some other writers define balance of trade as the difference between the value of merchandise (or goods) export and the value of merchandise imports, making it the same as goods balance or balance of merchandise trade. As per this definition, balance of trade takes into account only visible exports and imports. The visible exports and imports are those which are actually recorded at the ports.

Balance of Payments

The balance of payment is a statistical record of all the economic transactions of the residents of a country with the residents of rest of the world during a particular period of time, usually a year. An international economic transaction refers to the exchange of a good, service or asset, for which payment is required between the residents of one country with the residents of other countries. However, gifts and certain other transfers for which no payment is required are also included in a country's balance of payments. Thus, it is a flow of goods, services, gifts and assets between the residents of one country and residents of other countries during a year.

The balance of payments is one of the important statistical statements of a country. It reveals how many goods and services the country has been exporting and importing and whether the country has been borrowing from or lending money to the rest of the world. In addition, whether or not the central bank has added or reduced its foreign exchange reserves is reported in the balance of payment statistics. The knowledge about balance of payments will inform the government about the international position of the country and help it its formulation of monetary, fiscal and trade policies.

An important point about a country's balance of payments statistics is that, in accounting sense, they are always balance. This is because they are based upon the principle of *double-entry book keeping*. This means that each international transaction is recorded twice, once as a credit item and once as a debit item of equal amount. The reason for this is that, in general, every transaction has two sides. Credit transactions are those that involve the receipts of payments from foreigners and debit transactions are those that involve the making of payments to foreigners. Thus, each receipts of currency from residents of rest of the world is recorded as a credit item (a plus in the accounts) while each payment to the residents of the rest of the world is recorded as a debit item (a minus in the accounts).

Traditionally, the balance of payment statistics comprises two main sections, namely the current account and the capital account. The essential difference between the two is that the current account items refer to the income flows, while the capital account records changes in assets and liabilities.

Current Account

The current account records exports and imports of goods and services and unilateral transfers. The current account balance is the sum of *visible balance* and *invisible balance*. Trade balance is referred to as the visible balance because it represents the difference between receipts for exports of goods and expenditure on import of goods which can be visibly seen crossing national frontiers. The receipts of exports are recorded as credit in the balance of payments while the payments for the imports are recorded as debit. The invisible balance shows the difference between the revenue received for the export and payment made for imports of services such as shipping, tourism, insurance and banking. In addition, receipts and payments of interests, dividends and profits are recorded as the invisible items. It should be noted that unilateral transfers are included in the invisible balance. Unilateral transfers are payments or receipts for which there is no corresponding *quid-pro-quo*. Examples of such transactions are migrant worker's remittances to their family back home, payment of pensions to foreign residents, gifts which domestic residents receive from foreign residents and foreign aid. The net value of the balances of visible and invisible trade and unilateral transfers defines the balance on current account.

Capital Account

The capital account records all international transactions that involve a resident of the country concerned changing either his asset or his liabilities to residents of another country. Thus, it is concerned with the movement of financial capital into and out of the country. Capital comes into the country by borrowing, sales of overseas asset and investment in the country by foreigners. These items are referred to as "capital inflows" and are recorded as credit items in the balance of payments. In effect, capital inflows are decrease in the country's holdings of foreign assets or increase in the liabilities to foreigners. On the other hand, capital leaves the country due to lending, buying of overseas assets, and purchase of domestic assets owned by foreign residents as these involves payment to foreigners. These items represent "capital outflows" and are recorded as debits in the capital accounts. In effect, capital outflows are an increase are an increase in the country's holdings of foreign assets or decrease in the liabilities to foreigners. The summation of the capital inflows and outflows as recorded in the capital account gives the capital account balance.

Remaining Items in the balance of payments

The balance of payment accounts are completed by the entry of other minor items which do not fall comfortably into one of the standard categories. These are errors and omissions (statistical discrepancy) and changes in the official reserves and official liabilities. Errors and omissions or the balancing item reflect the difficulties involved in recording accurately all the transaction between domestic and foreign residents. Many of the reports statistics are based on sampling estimates so that some error is unavoidable. Problem may arise when one or other parts of a transaction take more than one year. Dishonesty and desire to avoid taxes may also create problem of underreporting. Finally, there are changes in the reserves of the country whose balance of payments are considering and changes in that part of the reserves of other countries that are held in the country concerned. Reserves are held in three forms, namely, in foreign currency, as gold and as Special Drawing Rights (SDR).

Foreign Exchange Rate

Simply, foreign exchange rate is the price of one currency in terms of other. Since there is an essential symmetry between the two currencies, the exchange rate may be defined in one of the two ways

- Cost in domestic currency of purchasing one unit of foreign currency. That is, domestic currency units per unit of foreign currency.
- Amount of foreign currency that foreign exchange rate may be bought for one unit of domestic currency. That is foreign currency units per unit of domestic currency.

Obviously, it can be noted that the second method is the reciprocal of the first method. While it is not important which method of expressing the exchange rate is employed, it is necessary to be careful when talking about a rise of fall in the exchange rate because the meaning will be different depending upon which definition is used. In the economic literature, the practice is to use the first definition.

In general, the foreign exchange rate is determined by the interaction of the market demand curve for and market supply curve of the foreign currency. That is, the exchange rate is determined just like the price of any commodity. On the demand side, one of the principal reasons people desire foreign currencies is to purchase goods and services from another country or to send a gift or investment income payment abroad. A second reason is to purchase financial assets in a particular country. The third reason people demand foreign currency is to avoid losses or make profits that would arise through changes in the foreign exchange rate. On the other hand, the total supply of the foreign exchange in a country consists of three sources. Firstly, it results from foreigner's purchasing home exports of goods and services or making unilateral transfers to the home country. A second source arises from foreign investment in the home country. Finally, foreigner's purchase of home currency to avoid losses or to make profits from changes in the exchange rate is the third source of supply.

Since the foreign exchange market brings together those people that wish to buy a currency (which represents the demand) with those that wish to sell the currency (which represents the supply), then the exchange rate can easily be determined by the intersection of the demand and supply of the currency.

Devaluation and Revaluation

The terms devaluation and revaluation refers to a legal redefinition of a currency's par value under a system of fixed exchange rates. Devaluation means the reduction in the external value of the country's currency unit, undertaken by government fiat or official proclamation. It means reduction of the official rate at which one currency is exchanged for another. It is the deliberate action which reduces the value of a country's currency in terms of another (exchange rate).

The government of the country may resort to the devaluation of its currency to eliminate or to reduce the deficits in the balance of payments. Devaluation encourages exports by cheapening them in foreign countries. On the contrary, devaluation has the effect of discouraging imports by making them more expensive within the country. For example, if the currency of a country is devalued, then its purchasing power in foreign countries automatically goes down. In other words, imported goods become more expensive than before. Hence, devaluation discourages imports into the country. At the same time, the purchasing power of the devalued currency increases in terms of foreign currencies as a consequence of devaluation. As a result, the foreigners start importing more goods from the country. This gives an incentive to the exporters of the country. Hence as a result of devaluation exports will increase and imports will fall.

Revaluation is the opposite of devaluation. Revaluation means an increase in the external value of the country's currency unit, undertaken by government or central monetary authority. It means deliberate increase of the official rate at which one currency is exchanged for another. It is an upward revision of the gold parity of the currency. When a currency is undervalued, the prices and costs in the country are low in relation to world price. The country has a strong competitive advantage in the world market for its exports, while its own demand for imports is comparatively low. The purpose of currency revaluation is to cause the home currency's exchange value to appreciate thus contracting the balance of payment surplus. The balance of payment surplus of the country grows, which makes the currency more undervalued. Therefore, the country decides to revalue its currency.

But changes in this direction are rare. A country with favorable balance of payment is under no pressure to take any corrective action. Examples of revaluation can be found in former West Germany and Holland in 1961. Their currencies had become undervalued at their existing parities and monetary authorities revalued them by about five per cent.

Depreciation and Appreciation

A certain change in the exchange rates is always possible and also a matter of everyday importance as is the case with any commodity market. The price does not remain the same on any two given days or period due to changes in economic or political conditions or seasonal variations in demand and supply and demand or the effects of factors such as rate of interest, investment climate in the country etc. like the price of any commodity exchange rate is also subject to variation. The terms depreciation and appreciation refers to the actual impact on the market exchange rate caused by redefinition of a par value or changes in exchange rate stemming from changes in the supply of or demand for foreign exchange. Thus, Changes in the external value of currency are known as depreciation or appreciation of currency.

By exchange depreciation is meant a decline in the rate of exchange of the country's currency in terms of another. It is a decline in the external value of the currency. Like devaluation, exchange depreciation of a country will tend to cheapen its domestic goods for the foreigners so that exports will be boosted up. At the same time, its imports will be costlier so that they tend to decline. Thus, imports will be checked and exports will be stimulated by depreciation. In other words, depreciation will ordinarily improve country's balance of trade and payments by reducing foreign exchange payments for imports and increasing the foreign exchange receipts from exports.

A currency is stated to have appreciated of become costly when there is a rise in the rate of exchange. It refers to a rise in the external value of domestic currency when the exchange market is moving whereby giving a lesser amount of domestic currency against a given amount of foreign currency. If demand for foreign currencies increases they will appreciate against home currency. Similarly, a decreased supply of foreign currencies, demand remaining the same will also cause appreciation of currencies. Appreciation like revaluation refers to the rise in the value of currency relative to another currency.

MODULE IV
INDIA AS A DEVELOPING ECONOMY

Meaning of a Developing Economy

Developing country is a term generally used to describe a nation with a low level of material well-being. They are mostly middle income countries and least-developed countries in Asia (excluding Japan); Central and Eastern Europe; the Middle East and Latin America and Africa. These economies have standards of living lower than developed economies and economies in transition. Many have deep and extensive poverty. Developing countries are usually importers, rather than developers, of innovations in science and technology. They also tend to be more vulnerable to economic shocks.

There are no official definitions of "developed" or "developing" countries in the UN system. Developing countries are in general, countries which have not achieved a significant degree of industrialization relative to their populations, and which have, in most cases a medium to low standard of living.

The World Bank’s main criterion for classifying economies is the gross national income (GNI) per capita. Based on its GNI per capita, every economy is classified as low income, middle income (subdivided into lower middle and upper middle), or high income. These are set each year on July 1. Economies were divided according to 2010 GNI per capita using the following ranges of income:

- Low income - $1,005 or less.
- Lower middle income - $1,006 -$3,975.
- Upper middle income - $3,976 - $12,275.
- High income - $12,276 or more

The World Bank classifies all low- and middle-income countries as developing but notes, "The use of the term is convenient; it is not intended to imply that all economies in the group are experiencing similar development or that other economies have reached a preferred or final stage of development. Classification by income does not necessarily reflect development status."

India as a Developing Economy

Since the per capita income is the usual measure of the standard of living, the definition for developing economy can be stated in terms of per capita income: "A developing economy is an economy where per capita income is rising." On this basis it is sure that after more than 61 years of planning Indian economy is stood as a developing economy. In almost all fields there are marked and drastic improvements which can be better understood by the explanation of the following features:

1. Increase in National income:

National Income is considered as an indicator of a nation's growth. In 1950-51 India's national Income is Rs.2,04,924 crore at 1999-00 base year price and it rose to Rs. 52,22,027 crore

at 2004-05 base year price in 2010-11.The growth rate of India's National Income is 6.9% in 2011- 12 even the economy is in the wave of global financial crisis.

2. Increase in Per capita income

Per capita income is considers as the best index of standard of living of people in a country. The average annual growth rate of per capita income is only 2% in 1950-51 it was Rs. 5,708 at 1999-00 base year price. But in 2010-11 the growth rate is 6.7% and it is Rs.36, 003 at 2004-2005 base year price. It is true that India's Per capita growth rate is low, because of excessive growth rate of population.

3. Improvement in Saving and Investment:

As National Income increases the saving and investment of the economy have also be stepped up. The rate of Investment as proportion of GDP was only 10% in 1950-51 and it rose to 36.5%in 2009-10.At the same time the rate of saving as a proportion of GDP was 10.2% and 32.2% in the respective years on current market prices. As a result of these there will be a marked improvement in capital formation of the country. The rate of capital formation in the last five decades is very high.

4. Change in Agriculture sector

After independence Indian agriculture sector witnessed a lot of changes. In 1950-51 around 69.7% of the people depend on agriculture. But according to the estimates in 2010-11 still agriculture is the single largest private sector occupation and 52% of people engaged in agriculture activities. The share of agriculture to GDP in 1950-51 was 55.4% while it declined to 13.9% in 2011-12.These show that the importance of agriculture sector is coming down. But the country achieved self sufficiency in food grains production. There should be marked changes in cropping pattern and Green revolution takes place in the mid of 1960's.

5. Change in Industrial sector

At the time of independence India's industrial structure was underdeveloped and backward. As a result basic and capital goods industries are given more priority in the early years of industrial development of the country. The growth rate in industrial sector is fluctuating. The share of industrial sector to GDP increased from 13.3% to 27% during 1950-51 and 2011-12respectively. Since independence industrial production marked a good improvement and a variety of industrial production structure is formed. The share of people participated in this sector increased from 12% to 28% during 1950-51to 2010-11.Major industries in India are; Textile, Food Processing, Cement, Paper and News Print industry, Leather, Steel, Auto mobile, Gems and Jewellery, Oil and Gas industry, Sugar industry, Civil aviation industry etc.

6. Change in tertiary sector

After the starting of planning, the highest rate of growth happened in tertiary sector. In 1950-51 it contributes only 28.5%, but it increased to 59% in 2011-12.Now the service sector is considered as India's work horse. The tertiary sector comprises; Trade, hotels, Transport and Communication, Financial and Insurance services, Real Estate, IT, Community, Social and Personal Services etc.

7. Change in foreign trade

Even though India's share in world trade is around 1%, it is highly diversified.

Before independence foreign trade means only import. But after independence India started export which

is favorable to Indian economy and adopt import substitution policy. Now India's trade policy is export promotion.

8. Social and institutional changes

The spread of education, urbanization, political democracy, transport system, new technologies etc. loosen the underling caste system and other social and institutional stringencies. This also shows India's wake up for a bright future.

9. Urbanization

Economic growth is associated with urbanization. The rate of urbanization clearly shows India's economic development. In 1951the rate of urbanization is only 17.3% but it increased to 27.8% in 2001 census.

10. Expansion in science and technology

India is Eighth among top 15 countries in the contribution of their scientists. India has over 1300 Research Institutes in different areas like atomic energy, space, defense, forestry, agriculture, electronics, health etc

11. Improvement in social overheads or infra-structure

Economic development is being assisted by the development in the means of transport and communication, banking system, education etc. A good deal of improvement has been made by India in this field. The Indian road net work system is now one of the largest in the world. The transport system in India has grown both in terms of capacity and modernization. The growth of commercial banks and other financial institutions are spectacular which helps to solve present financial crisis.

12. Crisis Management

As far as Indian economy is concerned weather and foreign exchange crisis are the main problems. But now these issues are managed to a greater extent. Even today most of the developed nations are failed to solve the recent Global Financial crisis India managed it successfully with less burden.

Indian economy, through economically backward it remained no longer in such a situation. More than six decades of development experiences created dynamism in country's economy and one can now hopefully say that it would sustain development in the future.

Major Issues: Poverty, Unemployment and Inequality

Even though India is one of the major developing economies in the world, it faces certain crucial issues in its developmental path. They are Poverty, Unemployment and Inequality. Only by solving these issues and looking from different angles these are to be removed.

POVERTY

The concept of Poverty

Poverty is a plague as it is prevalent in almost all countries in the world and it has many faces and dimensions. Therefore it is difficult to define the concept poverty in precise. Poverty is always defined according to the conventions of society in which it occurs[i]. But in the recent years, the concept of poverty has been refined and made more comprehensive. The New World requires better and more scientific ways to assess the concept of poverty in the society. Now its

multidimensional aspect is recognized and uses a multidisciplinary approach to assess poverty. Poverty is not simply a social phenomenon but also include economic, political, historical, geographical and cultural aspects.

Various attempts have been made by societies to define poverty. In human terms poverty means little to eat and wear, and in economic terms the poverty means the inability to attain a minimum standard of living[ii]. It is natural to view poverty as the failure to meet the basic requirements to maintain a minimum standard of living. This minimum standard of living may vary from society to society. While biological requirement and nutritional norms provide the most elementary concept of a minimum standard of living, modern understanding of poverty requires other factors such as school enrolment, infant mortality, immunization, malnutrition, women empowerment, overall standard of living, asset holding etc.

Poverty can be defined as a social phenomenon in which a section of the society is unable to fulfill even its basic necessities of life. In India the generally accepted definition of poverty emphasizes minimum level of living rather than a reasonable level of living. In economics there are two important classification of poverty; Absolute Poverty' and 'Relative Poverty'.

Absolute Poverty and Relative Poverty

Absolute Poverty is the sheer deprivation or non-fulfillment of bare minimum needs of existence- of food, shelter, health or education. It is based on the absolute needs of the people and people are defined as poor when some absolute needs are not sufficiently satisfied. Hence according to this type poverty is treated as deprivation. Most of the developing countries are experiencing such type. An absolute poverty line is based on the cost of minimum consumption basket based on the food necessary for a recommended calorie intake.

Relative Poverty is related with high income countries, where people are poor because they cannot maintain or equivalent to others in the society. There should be differences in living standards among the people. It reflects economic distress, despair and dissension that stem from serious inequalities in income and wealth .The relative poverty line varies with the level of average income. Relative poverty is based on inequality and differences in standard of living. According to the relative concept of poverty, people are poor because

From this classification we know that poverty is not inequality. Poverty is only one of the evil consequences of inequality. Whereas poverty is concerned with the absolute standard of living of a part of the society i.e.; the poor, inequality refers to relative living standards across the whole society.

Measurement of Poverty

Once we understand poverty, it is essential to measure it with its various dimensions. The measurement of poverty is needed to plan policies to check this global phenomenon. Many factors were listed, some of them are life expectancy, mortality, maternality, safe drinking water, pure air, women empowerment, energy consumption, literacy, asset holding, sanitation, primary health facilities, clean surroundings etc. most of these are derived with income. Therefore consumption data can be used to measure poverty.

Poverty Line

Poverty line is the most widely used measure for assessing poverty. Under this method, people are counted as poor when their measured standard of living is below a minimum acceptable level-known as Poverty Line. The poverty line in India is defined as 'the level of private consumption expenditure, which ensures a food basket that would supply the required amount of

calories'. Actually in India the Planning Commission estimates the poverty on the basis of Calorie intake. By considering age, sex, activity etc., Indian Council of Medical Research (ICMR) proposes 2400 calorie intake for the rural person per day and 2100 calorie per person per day in urban. The calorie requirements in the rural areas is higher because people engaged in heavy work more in rural areas than in urban areas.

POVERTY ESTIMATION IN THE INDEPENDENT INDIA

In independent India, the first official definition of poverty was given in 1962. This pegged the rural poverty line at a Monthly Family Income of Rs.100 and urban one at Rs.125.

Dandekar and Rath (1971)[iii] estimated poverty in terms of consumer expenditure needed a diet adequate at least inform of calories, they adopted 2250 calories per person per day as the norm for their study. According to them, the consumer expenditure necessary to obtain the minimum nutritional standard was an amount of Rs. 14.16 per capita per month at 1960-61 prices for rural India. Based on this norm, 30.92 percent of the rural population lies below the poverty line in 1961- 62, in India.

Bhrdhan (1974)[iv] adopted the poverty line of Rs 15 at 1960-61 all India rural prices as the minimum level of living, and also estimate poverty for 1967-68 period, taking Rs. 29.90 as minimum requirement and find that in 1960-61 about 38% of rural Indians and in 1967 – 68, 53 percent of rural Indians are below poverty line.

Vaidyanathan (1974)[v] adopted Rs. 21.44 as rural poverty in India at 1960-61.prices. To his estimate the rural poverty in India is 15.65percent.

Bhatty (1974) measured the incidence of poverty for the year 1968-69. He selected poverty lines in terms of Percapita income instead of Percapita consumer expenditure. He made use of the income distribution data collected by National Council of Applied Economic Research (NCAER) for 1968-69. In order to overcome arbitrariness in using a single poverty line, Bhatty made use of five poverty lines namely Rs. 180, Rs 240 Rs. 300, Rs. 360 and Rs. 420. percapita per annum at 1968-69 prices or its percapita monthly equivalent Rs. 15, Rs. 20, Rs. 25, Rs. 30 and Rs. 35. His results show that the poverty levels vary corresponding to different income levels. The corresponding rural poverty is 21.95 percent, 39.55 percent, 55.87percent, 69.70 percent, and 78.70 percent corresponding to monthly percapita income.

Ahluwalia’s (1978)[vi] “estimates shows a fluctuating trend in the incidence of poverty over time. Rural poverty in India declined from 53.4 percent in 1957-58 to 42 percent in 1960-61. Then it started rising from 42.3 percent to 57.9 percent during 1961-62 to 1967-68 and then declined to
47.6 percent in 1973-74.

Mahendra Dev (1988)[vii] estimated the poverty lines for the reference years by making use of the estimates derived by Bardhan (1974) for the year (1960-61). He adjusted the poverty lines by the Consumer Price Index of Agricultural Labourers (CPIAL) for the reference years. He found that the percentage of rural Indian population living below the poverty line was continuously declining from 46.4 percent in 1964-65 to 44.78 percent in 1972-73 and from 40.45 percent in 1977-78 to

33.20 percent in 1983-84. The Planning Commission (1981 and 1985) measured the extent of rural poverty for 4 years taking Rs 77 (at 1979-80 prices) percapita per month as the poverty line. In 1977-78, about 51.2 percent of rural population was poor as against

54.1 percent in 1972-73. It comes down to 40.4 percent in 1983-84. The Planning Commission calculates the poverty ratio on the basis of quinquennial Consumer Expenditure Surveys conducted by NSSO. The Planning Commission's estimates of the poverty ratio for 1987-88 indicated further decline in the incidence of poverty to 33.4 percent in 1987-88.

Criticising the Planning Commission's earlier estimates, Minhas, Jain and Tendulkar (1991) measured the incidence of poverty by using correct procedure for three years 1970-71, 1983 and 1987-88. They converted the poverty norms to prices prevailing in the year for which NSS consumer expenditure data are available. They worked out State Specific Cost of Living Indices. Then, applying these indices, they calculated State Specific Poverty norms for 1970-71, 1983 and 1987-88. The poverty norms for rural India were Rs. 33.01, Rs 93.16 and Rs. 122.63 for the years considered respectively. Corresponding to these poverty lines, the percentage of population below poverty lines were 57.3, 49.02 and 44.88 for the corresponding years.

Rohini Nayyar (1991)[viii] measured the poverty line for 13 years period from 1960-61 to 1983-84 and estimated the incidence of rural poverty. Her calculations are based on actual consumption data by broad category. She made use of the calorie norm of 2200 to arrive at the poverty line. To her estimates rural poverty fluctuates over the years.

Kakwani and Subba Rao (1992)[ix] attempted a study on rural poverty for the period 1973-86. They used relative price levels in the rural areas to arrive at the poverty lines. Using the price relatives and consumer price indices for agricultural labourers they worked out the State Specific Poverty Lines at the current prices for the years 1973-74, 1977-78, 1983 and 1986 – 87. According to their estimates the rural poverty continuously declined.

Tendulkar and Jain (1995)[x] estimated the incidence of poverty for 12 years from 1970-71 to 1992. They estimated the poverty lines for various years taking the Planning Commission's all India poverty line of monthly percapita total expenditure of Rs. 49.09 at 1973-74 prices. Urban Poverty profile of the different authors are given in the Appendix, Even though the earlier estimates of Planning Commission is based on this calorie norms which is criticised because of methodological defects and it cannot consider the other basic items like health, education etc. Therefore Planning Commission appointed an Expert Committee, under Suresh Tendulkar in 2008 and reported its recommendations in November 2009. The committee suggested a formula based on Consumption Expenditure for identifying BPL families. His recommendations are more scientific and there is some novelty in the measurement because Tendulkar committee uses a broad definition of poverty including expenditure for food, education, health etc., and uses consumer expenditure taking Mixed Recall Period as against Uniform Recall Period. According the committee the monthly consumption expenditure to measure poverty line is Rs. 446.68 per person per month in rural areas and Rs. 578.8 per person per month in urban areas. To their report India's poverty is 37.2 percent (2004-05) as against the Planning Commission's estimates of 27.5 percent in 2004-05 calculated on the basis of Dandekar- Rath formula based on calorie intake.

Table 4.1 Poverty Rates in Various NSSO Rounds

Year	Round	Poverty Rate (%)
1973-74	27	54.88
1977-78	32	51.32
1983	38	44.48
1987-88	43	38.86
1993-94	50	35.97
1999-00	55	26.10
2004-05	61	27.50
2009-10	66	21.9

Source: Planning Commission, March, 2011 and NSSO Data

Latest poverty estimates of Planning Commission are seen from the Table **4.1** Planning Commission estimates India's poverty both on the basis of Uniform Recall Period[xi] and Mixed Recall Period[xii]. It consider Cost of Living as the basis of poverty.

Table 4.2 Poverty in India, New Estimates

Uniform Recall Period			Mixed Recall Period	
Years	93-94	04-05	99-00	04-05
Rural	37.3	28.3	27.1	21.8
Urban	32.4	25.7	23.6	21.7
All India	36.0	27.5	26.1	21.8

Source: *Economic Survey*[xiii]

In opposition to Tendulkar committee, Dr. N.C. Saxena committee was appointed by Rural Development Ministry in August 2008. This committee argued for a New BPL criterion, which suggests automatic inclusion of socially excluded groups and automatically exclusion of those who are relatively well-off. The committee recommended a new methodology of Score Based Ranking and put forwarded that Rs. 700 per month per rural person and Rs. 1000 per month per urban person to maintain 2400 and 2100 calorie intake for a day. The committee estimates that India's poverty is 49.1 percent in 2004-05.

According to Arjun Sengupta committee appointed by National Commission for Enterprises in the Unorganised Sector (NCEUS) India's poverty is 77 percent. The Committee uses the same data of NSSO and takes the norm of Rs. 20 per day per person to measure the poverty line.

Based on World Bank's estimates (2005), 41.6 percent of Indians fall below the International Poverty Line this of $ 1.25 per day (PPP)[xiv]. In nominal terms Rs. 21.69 per day in urban area and Rs. 14.3/day in the rural area. They estimate 456 million Indians lived in poverty. World Bank's new International Poverty Line is based on $ 2 per day.

Abbijith Sen found out that if we took calorie norm even then the poverty is much higher i.e.; in urban 80 percent and in rural 64 percent of the Indians are lived below poverty line. This estimate is also very higher than official estimate.

Table 4.3: Poverty line, 1973-74 to 2004-05

Year	Rs per capita per month, current prices	
	Rural	Urban
1973-74	49.63	56.76
1977-78	56.84	70.33
1983	89.5	115.65
1987-88	115.2	162.16
1993-94	205.84	281.35
1999-2000	327.56	454.11
2004-2005	356.30	538.60

*Source*s: Planning Commission

Causes of Poverty in India

Poverty is not caused by any single reason. It is the outcome of the interaction of several factors; economic, non- economic, political, social, cultural, geographical etc.

1. Underdevelopment

The most important cause for poverty is the underdevelopment of the economy. Due to underdevelopment a large proportion of the people have go without even the basic necessities of life. With the low national income and percapita income the country cannot increase its aggregate consumption and investment. Hence the standard of living is also so low among the people. Even though there is much improvement in the development of the country after independence still we want to go a lot.

2. Inequality

The second important cause of poverty in India is inequality in income and wealth. Even the New Economic policies could not reduce the depth of inequality in India. Instead there is increase in inequality among the people.

3. Inadequate growth rate

In the early years of planning the growth rate of Indian economy is not high enough to check the problem of poverty. Even though economy railed in a high growth path in the mid of 2000 onwards the benefits are not trickle down to the poor sections of the society. Still the gap between rich and poor is increasing.

4. Large population

Even though the growth rate of population is coming down still the size of it is very large.

5. Therefore it is not capable to implement the poverty alleviation programmes successfully.

Unemployment

Another major cause for the growth of poverty is unemployment. The problem of unemployment is still so acute in the economy. Thus increasing unemployment and underemployment accentuate poverty.

6. Poor performance of agriculture sector

Still Indian agriculture is carried on largely with primitive techniques. High dependency on rain, small and scattered holdings, lack of inputs, exploitative land tenure system, competition from foreign markets, lack of storage and marketing facilities etc. are responsive to the poor performance of agriculture sector even after the Green Revolution.

7. Poor performance of industrial sector

In spite of much improvement in line with development of modern industries still performance is not up to the mark. Lack of dynamic entrepreneurs, lack of competitiveness, lack of skilled and trained workers, inadequate finance, irregular supply of power and raw materials, poor transport and methods of production etc. leads to slow industrialization of the country.

8. Inflation

Rise in price is an alarming problem to the economy. It is the poor who suffered a lot due to inflation. When prices are high the purchasing power of money falls and leads to impoverishment of the poor sections of the country.

9. Social factors

It is agreed that the poverty in India is the outcome of social factors. It includes caste system, joint family system, law of inheritance, lack of initiative and entrepreneurship etc. India is also poor in social overheads like education, health, medical facilities, illiteracy etc. The attitudes and aspirations of the people are not conducive to economic growth and development.

10. Political factors

Even after India escaped from the yoke of British exploitative administration still the political set up is not that much efficient to solve the problem of poverty. It is true that various programmes are initiated under five year plans. The Fifth Five Year Plan raised the slogan "Garibi Hatao" but still the poverty alleviation is a nightmare to Indian policy makers.

Thus the poverty in India is happened due to various reasons. Regional disparities, lack of investment, lack of proper implementation of public distributive system, lack of vocational training and education, migration of rural youth to cities etc. have also contributed to poverty in India.

Remedial Measures

Poverty is a tragedy not only for the individuals but also for the economy at large. As a result of this the remedial measures to poverty is emphasized. From the experiences of the economy we can suggest the following to alleviate poverty.

1. Rapid Economic Growth

Fast economic growth is a necessary condition for poverty alleviation programme for the following reasons: It changes the low income agricultural set up, helps to strengthen the redistributive activities of the government, made a radical change in production and distribution process, create more employment opportunities etc. Even there is the possibility of trickledown effect to economic growth.

2. Accelerate agricultural growth

No doubt that when there is agricultural growth it reduces the burden of poverty because majority of poor are lived with agriculture sector. So steps should be taken to solve the problems of small and marginal farmers.

3. Accelerate industrial growth

The industrial development will create more income and employment opportunities to the people. Through this the depth of poverty can be reduced.

4. Development of small- scale and cottage industries

In Indian economy small- scale and cottage industries have played a crucial role. This sector which being labour intensive, create more employment opportunities and help in the removal of poverty.

5. Land reforms

Land reforms as poverty alleviation measures aimed to break the old feudal socio-economic structure of land ownership. It aims to eliminate exploitation by providing security of tenure and regulation of rent. It also aims to bring direct contact between the state and the tiller and give social economic status of the landless by distributive measures.

6. Better Public Distributive System

Poverty can be reduced if people are ensured with essential commodities at fair prices. Therefore the government should establish a wide network of fair price shops to provide the essential commodities.

7. Control Population

Unless the population is not reduced, the additions to wealth production will be eaten up by the fresh torrent of babies. Therefore the planners should aim at the family planning measures to bring down the birth in the country.

8. Provision of Common Services and social Security

The government should spend for the provision of free common services like primary education, medical aid, potable drinking water, housing and other facilities to the people. This will increase their real consumption and make them feel better off and hence reduce the poverty.

9. Improve the Status of the Women

Gender equality can help to reduce poverty and encourage growth in variety of ways. Women are provided with direct access to institutional credit, direct membership in cooperatives, setting up of women organization etc.

10. Good Administrative Setup

Above all the success of any programme primarily depends on the effective working of the administrative machinery.

A Brief Review of Poverty Alleviation Programmes

Beginning with the launch of Integrated Rural Development Programme (IRDP, 1978) in the Sixth Five Year Plan, a number of PAPs have been formulated and implemented; many of them are have been restructured and formulated fresh from time to time . Among these PAPs the more important have been:

(a) Training of Rural Youth for Self-Employment (TRYSEM, 1979)

(b) National Rural Employment Programme (NREP, 1980)

(c) Rural Landless Employment Guarantee Programme (RLEGP, 1983)

(d) Million Wells Scheme (MWS, 1988)

(e) Nehru Rozgar Yojana (NRY, 1989).It is for the urban poor people.

(f) Jawahar Rozgar Yojana (JRY, 1989).NREGP and RLEGP are merged in this in 1989.

(g) Development of Women and Children in Rural Areas (DWCRA, 1992)

(h) Employment Assurance Scheme (EAS, 1993)

(i) Prime Minister Rozgar Yojana (PMRY, 1994)

(j) Prime Minister's Integrated Urban Poverty Eradication Programmes (PMIUPEP,1995)

Most of these programmes have been recently redesigned and restructured to improve their efficacy or impact on the poor. The important PAPs, presently in operation are;

- Self Employment Programme:
  Swarnjayanthi Gram Swarozgar Yojana (SGSY, 1999). This replaces IRDP, TRYSEM, DWCRA, SITRA, GKY and MWS and work for rural poor.
- Wage Employment Programme:
  - National Food for Work Programme (NFWP, 2004). It intensifies the generation of supplementary wage employment.

- Sampoorna Grameen Rozgar Yojana (SGRY, 2001). Rural Employment Generation Programme (REGP, 1995) was merged in SGRY in 2001.SGRY provide additional wage employment in the rural areas. Now this programme is entirely subsumed in NREGS with effect from April, 1, 2008.

➢ National Social Assistance Programme (NSAP, 1995). It provides social assistance to the rural poor.

➢ Urban Employment and Anti-poverty Programme:

- Prime Minister Rozgar Yojana (PMRY, 1993)
- Swarna Jayanti Shahari Rozgar Yojana (Golden Jubilee Urban Employment Scheme, 1997). This scheme integrates three PAPs for urban areas, viz.NRY, PMIUPEP and Urban Basic Services for the poor.

Unemployment

Another major developmental issue in Indian economy is unemployment. Although this problem had existed in the past; it has become more acute after the independence. The backwardness and increasing population are mainly responsible for this problem. The socio- economic consequences of unemployment are very dangerous. It has economic consequences for the individual as well as the society.

Unemployment means idleness of man power. It is the state in which labour possesses necessary ability and health to perform a job, but does not get job opportunities. In other words unemployment is the situation in which individuals are available for work, but are not able to find a work.

In order to explain the concept unemployment it is better to distinguish between the concepts like labour force and work force. The labour force refers to the number of persons who are employed plus the number who are willing to be employed. In India the labour force excludes

children below the age 15 and old people above the age 60 and mentally or physically handicapped. The work force includes those who are actually employed in economic activity. If we deduct work force from labour force we get the number of unemployment.

The unemployment rate means the number of persons unemployed per 1000 persons in the labour force.

The labour force participation rate and work force participation rate can be expressed in percentages and as given below.

Labour Force Participation Rate	=	Labour Force / Size of the population
Work Force Participation Rate	=	Work force / Size of the population

Types of unemployment

In every economy there is unemployment but the nature and magnitude differ according to the economic progress. Following are the important types of unemployment.

1. Voluntary unemployment

This is the main type of unemployment referred by the Classical economists. Voluntary unemployment is happened when people are not ready to work at the prevailing wage rate even if work is available. It is a type of unemployment by choice.

2. Involuntary Unemployment

Keynes analysed this type of unemployment. It is a situation when people are ready to work at the prevailing wage rate but could not find job.

3. Natural rate of Unemployment.

This is postulated by the Post-Keynesians. According to them in every economy there exists a particular percentage of unemployment.

4. Structural unemployment

This type of unemployment is not a temporary phenomenon. It is chronic and is the result of backwardness and low rate of economic development. The structural changes of an economy are the main reason for this type of unemployment.

5. Disguised Unemployment

When more people are engaged in a job than actually required, then it is called disguised unemployment. If a part of labour is withdrawn and the total production remains unchanged because their marginal product is zero. This is a part of structural unemployment.

6. Under Employment

This exists when people are not fully employment ie; when people are partially employed. In other words it is a situation in which a person is does not get the type of work he is capable of doing.

7. Open Unemployment

Mrs. Joan Robinson calls this type of unemployment as 'Marxian Unemployment'. Open unemployment is a situation where a large labour force does not get work opportunities that may yield regular income to them. It is just opposite to disguised unemployment. It exists when people are ready to work but are not working due to non-availability of work

8. Seasonal unemployment

Generally this type of unemployment is associated with agriculture because the unemployment rate is changed according to the season.

9. Cyclical Unemployment

It is generally witnessed in developed nations. This type of unemployment is due to business fluctuation and is known as cyclical unemployment.

10. Technological Unemployment

When the introduction of a new technology causes displacement of workers it is called technological unemployment.

11. Frictional Unemployment

It is a temporary unemployment which exists when people moved from one occupation to another. It will take time lag in transferring one work to another. The market imperfections are the main reason for this.

Measurement of unemployment in India

The National Sample Survey Organization (NSSO), which provides estimates of the rates of unemployment in India on the basis of its quinquennial surveys, uses three different concepts. They are Usual Status Unemployment, Current Weekly Status unemployment and Current Daily Status unemployment.

I. Usual Status Unemployment (US)

Here the reference period is 365 days. The usual status gives an idea about long-term employment (or chronic and open employment) during the reference year. A person is considered unemployed on Usual Status basis, if he/she was not working, but was willing to work for the major part of the reference year (more than 183 days) but did not get work for even 183 days. Dividing the usual status unemployment by the size of the labour force, we get unemployment rate by usual status. This measure is more appropriate to those in search of regular employment (educated and skilled persons) who may not accept casual work.

II. Current Weekly Status Unemployment (CWS)

Here the reference period is one week .A person is considered unemployed by Current Weekly Status, if he/she had not worked even for one hour during the week, but was seeking or was available for work. The estimates are made in terms of the average number of persons unemployed per week. The Current Weekly Status approach gives an idea about temporary unemployment (or chronic plus temporary unemployment) during the reference week. Current Weekly Status is used by the agencies like Inter National Organisations (ILO) to estimate employment and unemployment rates based on weekly reference period for international comparison. Dividing the weekly status unemployment by the size of the labour force, we get unemployment rate by weekly status.

III. Current Daily Status Unemployment (CDS)

Here the reference period is each of the 7 days, preceding the date of survey in each of these days. It records the activity status of a person for each day of the 7 days preceding the survey i.e. persons who did not find work on a day or some days during the survey week. The Current daily status approach gives a composite or comprehensive measure of unemployment, i.e., it is a measure of chronic and temporary unemployment as well as under employment. Dividing the current daily status unemployment by the size of the labour force, we get unemployment rate by usual status.

The current daily status gives the most faithful picture of unemployment situation.

Magnitude of unemployment in India

A comparison between different estimates of unemployment in 2009-10 indicates that the CDS estimate of unemployment is the highest (Table 4.8). The higher unemployment rates according to the CDS approach compared to the weekly status and usual status approaches indicate a high degree of intermittent unemployment. Interestingly, urban unemployment was higher under both the usual principal and subsidiary status (UPSS) and current weekly status (CWS) but rural unemployment was higher under the CDS approach. This possibly indicates higher intermittent or seasonal unemployment in rural than urban areas, something that employment generation schemes like the MGNREGA need to pay attention to. However, overall unemployment rates were lower in 2009-10 under each approach vis-a-vis 2004-05.According to NSSO report of 2011, 6.1 is the unemployment rate.

Table 4.8: All-India NSS 66th Round Rural and Urban Unemployment Rates

Si No	Estimates	Rural (2009-10)	Urban (2009-10)	Total (2009-10)	Total (2004-15)
1	UPSS	1.6	3.4	2.0	2.3
2	CWS	3.3	4.2	3.6	4.4
3	CDS	6.8	5.8	6.6	8.2

Source: NSSO

Labour force participation rates (LFPR) under all three approaches declined in 2009-10 compared to 2004-05 (Table 4.2). However, the decline in female LFPRs was larger under each measure in comparison with male LFPRs which either declined marginally (UPSS), remained constant (CWS), or increased marginally (CDS).

Table 4.2 All-India Employment and Unemployment Indicators (per 1000)

Indicators	NSS 66th Round (2009-10)			NSS 61th Round (2004-05)		
	Male	Female	Total Person	Male	Female	Total persons
UPSS						
LFPR	557	233	400	559	294	430
Work Participation Rate	546	228	392	547	287	420
Unemployment Rate	20	23	20	22	26	23
CWS						
LFPR	550	207	384	550	257	407
Work Participation Rate	532	198	370	527	244	389
Unemployment Rate	33	43	36	42	50	44
CDS						
LFPR	540	179	365	538	215	381
Work Participation Rate	507	164	341	496	195	350
Unemployment Rate	61	82	66	78	92	82

Source: Key Indicators of Employment and Unemployment in India, 2009-10, NSSO.

Causes of unemployment in India

Following are the important causes of unemployment in India

1. Rapid population growth
2. Slow growth of the economy
3. Decay of small scale and cottage industries
4. Low rate of capital formation
5. Defective planning
6. Slow growth of agriculture sector
7. Global financial crisis
8. Illiteracy
9. Lack of training facilities

Remedial Measures for unemployment

In order to solve the problem of unemployment there is both government measures and other measures. It includes the following measures.

1. Rapid growth and expansion of the economy
2. Establishment of more work and training centers
3. Development of small scale and cottage industries
4. Establishment of poverty eradication programmes
5. Liberal institutional finance and self employment programmes
6. Establishment of more employment exchanges
7. Introduction of population control measures
8. Introduction of more public works programmes
9. Reduce illiteracy
10. Stress on vocational and technical education

The Concept of Inequality

While the concept of poverty is rooted in the “lack of access” or “a low level of access” to food, nutrition, shelter, education and other services. Inequality is related to “unequal access” or “different degrees of access” of different individuals or groups of individuals to opportunities, services and benefits. Inequality is, thus, a more general concept than poverty. It looks at the ***relative levels of access*** of different groups to development opportunities and benefits. The “different levels of access” in the concept of inequality also include the low level of access below which people are considered poor. In fact, the low level of access or the limit (like for example, the calorie limit for consumption) that may be set for defining poverty will itself include a number of lower levels of access.

Inequality in India

India is shining for only a select few. The impressive economic growth of our country has brought smiles on the faces of the rich and the powerful even as the rest suffer in distress and drudgery. This was revealed by the Human Development Report, 2011 (HDR) released by Planning Commission. The report highlights the skewed income and wealth distribution in India and the widening gap between the rich and the poor. According to HDR 2011, inequality in India for the period 2000-11 in terms of the income Gini coefficient was 36.8. India's Gini index was more favourable than those of comparable countries like South Africa (57.8), Brazil (53.9), Thailand (53.6), Turkey (39.7), China (41.5), Sri Lanka (40.3), Malaysia (46.2), Vietnam (37.6), and even the USA (40.8), Hong Kong (43.4), Argentina (45.8), Israel (39.2), and Bulgaria (45.3) which are otherwise ranked very high in human development.

There are three important types of inequality exist in India, namely inequality in income and consumption, inequality in assets and regional inequality. These three forms of inequality are interrelated and mutually reinforcing. The Government of India has been concerned about rising inequalities and uneven distribution of the benefits of growth. Accordingly, the thrust of the 11th Five-Year Plan (2007-12) was on inclusive growth. The forthcoming 12th Five-Year Plan is expected to deepen and sharpen the focus on inequalities.

Inequality in Income and Consumption

Let us look at levels of inequality in income or consumption. Consumer expenditure of households is a good proxy for income, at least in the lower classes. A study of inequalities in levels of consumption will by itself be useful in an economy where agriculture, the unorganised sector, payment of wages in kind and the non-monetised sector still play an important role. Such an analysis will be able to pinpoint attention on specific areas of concern in the consumption pyramid. Let us, therefore, turn to levels of inequality in consumption.

The household consumer expenditure surveys of the NSSO provide the levels of consumption of expenditure in the population by Monthly Percapita Consumer Expenditure (MPCE) classes. The Average MPCE of the rural people in India is only Rs.1054 and in Urban it is Rs.1984[xv].

A comparison of the share of the bottom 10 per cent (or 20 per cent or 50 per cent) of the population in total consumption with that of the top 10 per cent (or 20 per cent or 50 per cent) of the population brings out dramatically the extent of inequality in consumption. The inequality situation is worse in urban areas than in rural areas. This is so in all States and Union Territories. Inequality in consumption is declining, *albeit* slowly, in rural areas according to all measures of inequality. On the other hand, urban inequality shows no sign of any decline.

Table: 4.3 Share of Household Expenditure by Percentile Groups of Households (in %)

Percentile groups of Households	1989-90	1994	1997	2004-05
Lowest 20 percent	8.8	9.2	8.1	8.1
Second quintile	12.5	13.0	11.0	11.3
Third quintile	16.2	16.8	15.0	14.9
Fourth quintile	21.3	21.7	19.3	20.4
Highest 20 percent	41.3	39.3	46.1	45.3
Highest 10 percent	27.1	25.0	33.5	31.1

Source: Various NSSO Report

Inequality in Assets

Incomes are derived from two main sources. Namely, assets like land, cattle, shares and labour etc. In India a few own a large chunk of income-earning assets therefore the distribution of assets is extremely unequal. The top 5 per cent of the households possess 38 per cent of the total assets and the bottom 60 per cent of households owning a mere 13 per cent. The disparity is more glaring in the urban areas where 60 per cent of the households at the bottom own just 10 per cent of the assets. Predictably, asset accumulation is minimal among the agricultural labour households in rural areas and casual labour households in urban areas. But the asset distribution is even more unequal in the urban than in the rural areas. At the one extreme there are highly rich households of industrial, commercial, financial, and real estate magnates and some ex-princes and political leaders. They own enormous assets and running for huge profits. On the other extreme there are slums, and pavement dwellers, unemployed and casual labourers, independent workers providing petty services etc. who generally hold negligible assets.

Regional Inequality

Third important type of inequality that India faces is the regional inequality. Some states are economically and socially advanced while others are backward. Even within each state some regions are more developed while others are primitive. The co existence of relatively developed and economically depressed states and even regions within each state is known as regional inequality. The existence of regional inequality creates social, economic and political issues. The regional inequality is so prominent in India in the case of HDI Value, growth of the economy, poverty, unemployment, education, health, monthly percapita expenditure, rural- urban divide etc.

The India Human Development Report, 2011 shows that India has a HDI value of 0.467. The HDI is the highest for Kerala (0.790)[xvi] followed by Goa (0.617) and then Punjab (0.605) and the lowest for Chhattisgarh (0.358), Odisha (0.362) and Bihar (0.367). While the HDI scores across states show little variation the variation in the sub-indices for education and health show a greater degree of variation. The income index shows the least degree of variation. The major states are distributed between the categories of countries with 'Medium' and 'Low Human Development' as per the HDR 2011 classification. Kerala is in the 'Medium HDI' category. Other major states in this group are Punjab, Himachal Pradesh, Haryana, Maharashtra, Tamil Nadu, Karnataka, Gujarat, West Bengal and Uttarakhand. Nine other states, namely Andhra Pradesh, Assam, Uttar Pradesh, Rajasthan, Jharkhand, Madhya Pradesh, Chhattisgarh, Bihar and Odisha fall in the 'Low HDI' category India is ranked 134 out of 187 countries in the Global HDI,2011.

The best performer in terms of growth in 2009- 10 was Uttarakhand, followed by Odisha, Chhattisgarh, and Gujarat and the worst performers were Karnataka, Rajasthan, and Jharkhand. States with above 10 per cent growth rate for the period 2004-5 to 2009-10 are Uttarakhand, followed by Maharashtra, Gujarat, and Bihar.

The state-wise estimates of poverty as recomputed by the Tendulkar Committee show that the highest poverty headcount ratios (PHRs) for 2004-5 exist in Odisha (57.2 per cent), followed by Bihar (54.4 per cent) and Chhattisgarh (49.4 per cent) against the national average of 37.2 per cent.

The unemployment rate (per 1000) according to usual status(adjusted) as per the NSS 66th round 2009-10 among the major states is lowest in Rajasthan(4) and highest in Kerala(75) in rural areas and the lowest in Gujarat(18) and highest again in Kerala(73) and Bihar(73) in urban areas.

In the area of education, Madhya Pradesh has the highest GER (6-13 years) in 2008-9 while Punjab has the lowest. Pupil-teacher ratios in primary and middle/basic schools are the lowest in Himachal Pradesh and high in states like Bihar and Uttar Pradesh.

Health-wise, Kerala is the best performer and Madhya Pradesh the worst in terms of life expectancy at birth (both male and female) during 2002-6. IMR in 2010 is also the lowest in Kerala and highest in Madhya Pradesh. Kerala has the lowest and Uttar Pradesh the highest birth rate in 2010, followed by Bihar and Madhya Pradesh. Odisha has the highest and interestingly West Bengal the lowest death rate.

The MPCE indicator shows that there is disparity both in the MPCE and food share across states. Bihar has the lowest MPCE of Rs 780 with 65 per cent food share in rural areas and Rs 1238 with 53 per cent food share in urban areas whereas Kerala has the highest MPCE of Rs 1835 with 46 per cent food share in rural areas and Rs 2413 with 40 per cent food share in urban areas. States with low average MPCE tend to have a higher share of food in total consumer expenditure as food is the primary need for survival and takes up a larger proportion of overall expenditure in the poorer sections of population. The top states spending more than the national average on food items both in rural and urban India are Bihar, Assam, Odisha, and Jharkhand.

Turning to the rural urban gap, we begin with the Monthly per capita expenditure (MPCE) defined first at household level to assign a value that indicates level of living to each individual or household. Based on the 66th round (2009-10) of the National Sample Survey (NSS), average MPCE [Modified Mixed Reference Period (MMRP) based] is Rs. 1054 and Rs.1984 respectively for rural and urban India at the all India level indicating rural-urban income disparities. Out of the MPCE, the share of food is Rs. 600(57 per cent) and Rs. 881(44 per cent) for rural and urban India respectively which shows that food share is more in rural India as compared to urban India.

Causes of Inequality in India

1. Private ownership of means of production
2. Poverty of the people
3. Law of inheritance
4. Concentration of economic power in the hands of a few
5. Highly unequal asset distribution
6. Inadequate employment generation
7. Inadequate development of the economy

8. Differential regional growth
9. Inequalities in professional training
10. Low investment in social sectors
11. Use of capital intensive technique of production
12. Failure of implementation of land reforms
13. Tax evasion and of the richer sections of the community
14. Inflation
15. Privatisation and globalisation

Remedial measures

In order to find out the remedial measures for inequality it is better to solve first the real causes of it in the country. Any how the following are the some of the measures to solve inequality.

1. Reduction in the concentration of economic power
2. Development of backward areas
3. Better distribution of income and wealth
4. Land reforms
5. Creating more employment opportunities
6. Provide more social security measures
7. Control of black money
8. Progressive income tax
9. Control of monopolies and trade restriction practices
10. High taxes on luxuries
11. Change in inheritance law
12. Use of labour intensive technique of production
13. More investment in social sectors
14. Control of inflation
15. Population control

Role of NITI Aayog

Planning commission served as the planning vehicle for close to six decades with a focus on control and command approach. Planning Commission was replaced by a new institution – National Institution for Transforming India, also called NITI Aayog on January 1, 2015 with emphasis on 'Bottom –Up' approach to envisage the vision of Maximum Governance, Minimum Government, echoing the spirit of 'Cooperative Federalism'. NITI Aayog is the premier policy 'Think Tank' of the Government of India, providing both directional and policy inputs.

Administrative Composition

- Chairperson: Prime Minister
- Vice-Chairperson: To be appointed by Prime-Minister
- Governing Council: Chief Ministers of all states and Lt. Governors of Union Territories.
- Regional Council: To address specific regional issues, Comprising Chief Ministers and Lt. Governors Chaired by Prime Minister or his nominee.
- Adhoc Membership: 2 member in ex-officio capacity from leading Research institutions on rotational basis.
- Ex-Officio membership: Maximum four from Union council of ministers to be nominated by Prime minister.
- Chief Executive Officer: Appointed by Prime-minister for a fixed tenure, in rank of Secretary to Government of India.
- Special Invitees: Experts, Specialists with domain knowledge nominated by Prime-minister.

The NITI Aayog's creation has two hubs called "Team India Hub" and "Knowledge and Innovation Hub".

1. The Team India Hub: It leads the participation of Indian states with the central government.
2. The Knowledge and Innovation Hub: It builds institution's think tank capabilities.

NITI Aayog is additionally creating itself as a State of the Art Resource Center, with the essential resources, knowledge, and skills that will empower it to act with speed, advance research and innovation, bestow crucial policy vision to the government and manage unforeseen issues. The reason for setting up the NITI Aayog is that people had expectations for growth and development in the administration through their participation. This required institutional changes in administration and active strategy shifts that could seed and foster substantial scale change.

The NITI Aayog is based on the 7 pillars of effective Governance. They are:

1. Pro-people: it fulfills the aspirations of society as well as individuals
2. Pro-activity: in anticipation of and response to citizen needs
3. Participation: involvement of citizenry
4. Empowering: Empowering, especially women in all aspects
5. Inclusion of all: inclusion of all people irrespective of caste, creed, and gender
6. Equality: Providing equal opportunity to all especially for youth
7. Transparency: Making the government visible and responsive

Objectives of NITI Aayog

- To evolve a shared vision of national development priorities, sectors and strategies with the active involvement of States.
- To foster cooperative federalism through structured support initiatives and mechanisms with the States on a continuous basis, recognizing that strong States make a strong nation.
- To develop mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government.
- To ensure, on areas that are specifically referred to it, that the interests of national security are incorporated in economic strategy and policy.
- To pay special attention to the sections of our society that may be at risk of not benefiting adequately from economic progress.
- To design strategic and long-term policy and programme frameworks and initiatives, and monitor their progress and their efficiency. The lessons learnt through monitoring and feedback will be used for making innovative improvements, including necessary mid-course corrections.
- To provide advice and encourage partnerships between key stakeholders and national and international like-minded Think tanks, as well as educational and policy research institutions.
- To create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and other partners.
- To offer a platform for resolution of inter-sectoral and inter-departmental issues in order to accelerate the implementation of the development agenda.

- To maintain a state-of-the-art Resource Centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stakeholders.
- To actively monitor and evaluate the implementation of programmes and initiatives, including the identification of the needed resources to strengthen the probability of success and scope of delivery.
- To focus on technology upgradation and capacity building for implementation of programmes and initiatives.
- To undertake other activities as may be necessary in order to further the execution of the national development agenda, and the objectives mentioned above.

NITI Aayog's entire gamut of activities can be divided into four main heads:

1. Design Policy & Programme Framework
2. Foster Cooperative Federalism
3. Monitoring & Evaluation
4. Think Tank and Knowledge & Innovation Hub.