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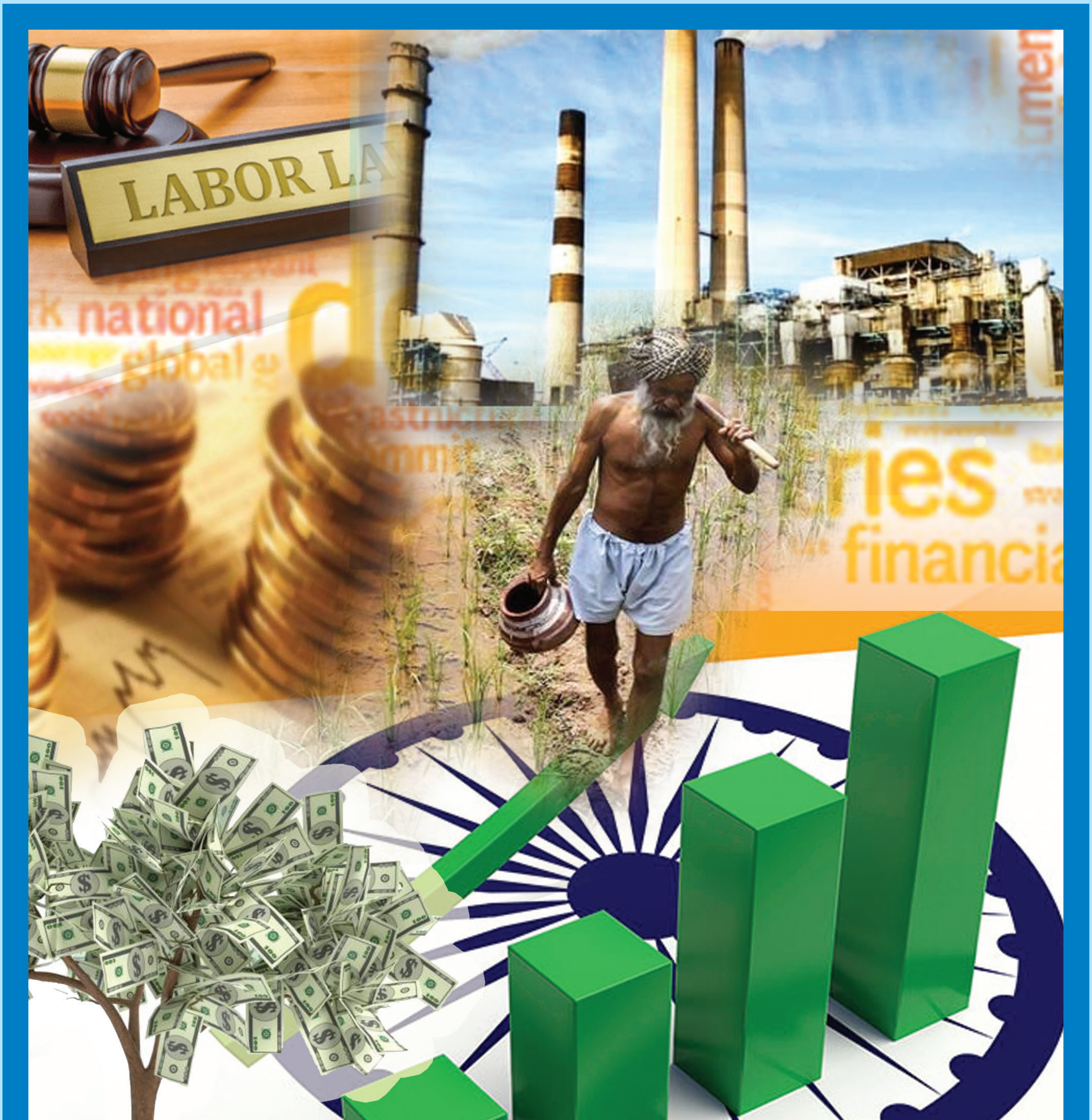
BECE-146
Indian Economy II

Indira Gandhi National Open University
School of Social Sciences,



BECE 146

INDIAN ECONOMY - II

School of Social Sciences
Indira Gandhi National Open University

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COURSE INTRODUCTION

The present course (Indian Economy II) is a sequel to the earlier course on Indian Economy I you studied in your previous semester. This course deals with two major policy areas viz. (i) the macroeconomic policies and (ii) the sectoral growth and development process in the economy. The course is distributed over four blocks/themes and has 12 units.

The first block (Block 1) is on 'Macroeconomic Policies'. You may be aware that 'monetary policy' and 'fiscal policy' are the two important policy options with the government for effecting the sectoral growth process in the desired manner. The two policies need due calibration. This means that they should be employed in a mutually complementary manner. It also requires to be in sync with the required policy atmosphere for facilitating the 'trade and investment' needs as also take care of the 'labour market' concerns. In view of this, Block 1 focuses on four important areas viz. (i) Monetary Policy (Unit 1), (ii) Fiscal Policy (Unit 2), Trade and Investment Policy (Unit 3) and (iv) Labour Laws and Regulations (Unit 4).

The agricultural sector in the Indian economy continues to cater to a significantly large proportion of its labour force (42% in 2019). With comparatively low productivity levels, the sector demands significant capital infusion for its modernisation. The sector requires major reforms in its market linkages and agricultural policies. Keeping these factors in view, Block 2 on 'Agricultural Sector' focuses on four important dimensions of Indian agriculture viz. (i) Performance of Agricultural Sector (Unit 5), (ii) Agrarian Relations and Market Linkages (Unit 6), (iii) Capital Formation and Productivity (Unit 7) and (iv) Agricultural Policy (Unit 8). The expected absorption of excess low productivity agricultural workers in the relatively higher non-farm industrial sector has been slow in India. With this concern in view, Block 3 of the courses deals with the 'Industrial Sector'. It focuses on two major areas viz. (i) Industrial Growth and Policy (Unit 9) and 'Small Scale Industries' (Unit 10). Block 4 of the course is on the 'Services Sector' of Indian Economy. In terms of its GDP share, the service sector in India has overtaken the industrial sector but its employment absorption needs policy focus. Keeping this in view, this block focuses on two areas viz. Features of Services Sector (Unit 11) and Policy Issues for Services Sector (Unit 12).

As pointed out in the Course Introduction of Indian Economy I, our endeavour is to keep the content of the course centred around 'concepts and methods'. This is with a view to making the contents, as far as possible, 'time invariant'. Statistical data, wherever presented, are meant to give you an exposure to the 'computational aspects of sectoral development indicators'. For instance, to compute a measure of agricultural or industrial productivity, the basic data you need is on 'input' and 'output'. Likewise, for assessing the contribution of sectors to the GDP, we need sectoral data on income. Calculation of productivity indicators is sensitive to the periods for which they are computed. In other words, with more recent data becoming available, they need to be computed afresh. Keeping these factors in view, the course gives exposure to the various 'data sources'. Once again, the report of the annual Economic Survey is an important single data source on the sectoral dimensions of Indian economy. Being an annual publication, and uploaded online just before the presentation of the 'union budget', it presents data on sectoral performance. With the invariable time lag in the collection and compilation of data by different departments and agencies, in any report of Economic Survey, you would find data on many aspects pertaining to a much earlier time point. Students are advised to make use of this important data source and attempt fresh computations from time to time. This will help them to remain abreast with the latest trends in the 'sectoral growth profiles' of the Indian economy.

BLOCK 1
MACROECONOMIC POLICIES

BLOCK 1 MACROECONOMIC POLICIES

Block 1 of this course is on 'Macroeconomic Policies'. It deals with four broad areas viz. Monetary Policy, Fiscal Policy, Trade and Investment Policy and Labour Laws and Regulations.

Unit 1 is on '**Monetary Policy**'. It begins with a discussion on the 'sources of money supply'. Different instruments of monetary policy like reserve ratio, bank rate and 'repo and reverse repo rates' are explained in the unit. The broad objectives of Monetary Policy in terms of: (i) price stability, (ii) exchange rate stability, (iii) economic growth and (iv) employment generation with export promotion (in a manner as to take care of the concerns of equity) are explained. Recent changes in the Monetary Policy Mechanism in India is outlined.

Unit 2 is on '**Fiscal Policy**'. It begins with an outline of the broad 'types of fiscal policy' along with its implications. A brief review of fiscal policy in India, with a thrust on the policies pursued since the 1990s, is then made. Different instruments of fiscal policy like (i) taxation, (ii) expenditure and (iii) debt are explained. The concept of 'fiscal deficit' is also discussed.

Unit 3 is on '**Trade and Investment Policy**'. The unit discusses the broad objectives of trade policy. This is done in terms of two basic approaches viz. 'import substitution industrialisation (ISI)' and 'export led growth (ELG)'. The concepts of 'convertibility' and 'deficits of accounts' is explained. Distinction between the FDI policy and the FII policy is outlined. Significance of 'regionalism' in terms of 'bilateralism' and 'multilateralism' is discussed.

Unit 4 is on '**Labour Laws and Regulations**'. The unit begins with an outline of the 'labour policies in India prior to independence'. The various labour laws for the organised sector workers and those for the unorganized sector workers are separately explained. Recent 'labour reform measures' are discussed.

UNIT 1 MONETARY POLICY*

Structure

1.0 Objectives

1.1 Introduction

1.2 Sources of Money Supply

 1.2.1 Reserve Money

 1.2.2 Foreign Capital Flows

1.3 Monetary Policy Instruments

 1.3.1 Reserve Ratios

 1.3.2 Bank Rate

 1.3.3 Repo and Reverse Repo Rates

1.4 Objectives of Monetary Policy

 1.4.1 Price Stability

 1.4.2 Exchange Rate Stability

 1.4.3 Economic Growth

 1.4.4 Export Promotion, Employment Generation and Equity

1.5 Changes in the Monetary Policy Mechanism in India

 1.5.1 Liquidity Adjustment Facility (LAF)

 1.5.2 Market Stabilisation Scheme (MSS)

 1.5.3 Marginal Standing Facility (MSF)

1.6 Let Us Sum Up

1.7 Key Words

1.8 Some Useful Books and References

1.9 Answers/Hints to Check Your Progress Exercises

1.0 OBJECTIVES

After reading this unit, you will be able to:

- state the broad macroeconomic objectives of monetary policy;
- describe the concepts behind the sources of money supply;
- verify/show that aggregate bank deposits are directly proportional to 'reserve money' and inversely proportional to the sum of 'CRR and liquid cash' in the economy;
- explain the instruments of monetary policy;
- discuss the specific objectives of monetary policy;
- outline the process of 'monetary transmission mechanism' with its consequent impacts on GDP and employment levels; and

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- delineate the changes in the monetary policy mechanism of India after the 1990s.

1.1 INTRODUCTION

Monetary policy seeks to achieve multiple objectives like economic stability, growth and equity. Monetary policy encompasses the overall monetary management in an economy. The responsibility of monetary policy is performed by the central bank of a country which in the case of India is the Reserve Bank of India (RBI). The RBI regulates money supply in the economy (through the banking system) striving to achieve three basic macroeconomic objectives viz. (i) ensure the money supply required for the economic expansion, (ii) increase output and stabilise prices and (iii) maintain the rupee value from excessive appreciation or depreciation of the same (i.e. exchange rate stability). By performing these objective, it helps in raising the level of aggregate demand through the optimum levels of consumption and investment which, taken together, enhances economic growth.

This unit first recapitulates some important theoretical concepts on money supply and then proceeds to discuss the major policy instruments used to regulate the same. The mechanism of monetary policy has evolved itself over time with some major changes having taken place in it in the post-1991 years. The unit delineates some of these changes.

1.2 SOURCES OF MONEY SUPPLY

In a modern economy, money supply can be broadly considered in its two forms viz. cash money and credit money. Central banks usually classify '*aggregate money supply*' on the basis of the '*liquidity*' of different monetary assets. Liquidity means how quickly an asset can be converted into cash money. Thus, currency in hand is the most liquid by which we can readily exchange goods and services. From this standpoint, based on their descending order of liquidity, supply of money can be categorised into the following four categories viz. M_1, M_2, M_3 and M_4 (i.e. M_1 is the most liquid form of money while M_4 is relatively the least liquid).

$$M_1 = C + DD + OD \tag{1.1}$$

where C refers to currency (including coins and paper notes) held by public, DD refers to demand deposits with commercial banks and OD refers to 'other deposits' (e.g. deposits with RBI by financial institutions like IDBI, foreign central banks or international financial institutions like IMF, WB, etc.). It is the most liquid and is as per a narrow concept and hence also called as 'narrow money' (in contrast to M_4 which is based on a broader concept and hence called 'broad money'). M_1 is also considered as the 'monetary base' of an economy. In contrast to M_1, M_2 is defined in a relatively broader concept as:

$M_2 = M_1$ + savings deposits in post offices (1.2)

M_3 and M_4 are based on still broader concepts and are respectively defined as:

$M_3 = M_1$ + 'net time (fixed) deposits' with commercial banks (1.3)

$M_4 = M_3$ + savings with post office (excluding 'national savings certificates') (1.4)

1.2.1 Reserve Money

The second most important source of money supply in an economy is the money generated as '*credit money*' by the commercial banks. It is the loans extended by the banks to the public which depends on certain factors like: (i) 'cash reserve ratio' (CRR: discussed in sub-section 1.3.1) and (ii) cash and demand deposits made from time to time by the general public with the banks. The 'scheduled commercial banks' (SCBs) generate 'credit money' in proportion to 'a multiple of the cash deposits' (called '*deposit multiplier*': DM) held by them. CRR and DM are inversely related i.e. higher the CRR, lower will be the value of the deposit multiplier and therefore lesser will be the capacity of the banking system to create credit money and vice versa.

M_1 defined above is also called as '*high powered money*' or 'reserve money'. As said above, it is also referred to as the 'monetary base' of an economy. The RBI can increase the quantity of the high powered money by purchasing securities or government debt instruments. We can show that the supply of 'high powered money' (H) influences the capacity of the banking system in credit creation. For this, let us suppose that the size of the bank deposits is D 'b' is the fraction of the total bank deposits which the public wants to hold in cash and the cash reserve ratio is 'x'. Then, reserves with the RBI (R) = x * D and currency with the banks and the public (C) = b * D. Now, the high powered money, H, is obtained as:

$$H = bD + xD = (b + x) * D \qquad (1.5)$$

$$\text{or } D = \frac{H}{b+x} \qquad (1.6)$$

The size of the total deposits in an economy is thus a multiple of the high powered money which depends upon three factors: (i) quantity of high powered money (H), (ii) cash reserve ratio (x) and (iii) fraction of the total bank deposits (D) which the public wants to hold in cash. In other words, the high powered money 'H' is a fraction of the total deposits (D) in which the multiplying factor is '$b + x$' i.e. H = D * ($b + x$).

1.2.2 Foreign Capital Flows

Apart from the above mentioned channels (M_1 to M_4) of money supply, '*foreign capital flows*' (both inflows and outflows) also affect money supply. The dynamics behind this phenomenon is better understood with the help of the balance sheet of the Reserve Bank of India. In simple words, when foreign capital flows into India, the assets side of the balance sheet of the RBI increases. This results in the '*appreciation*' of rupee. To keep the value of the rupee stabilised, RBI issues more domestic currency. This causes the liability side of the balance sheet to increase. In other words, to prevent excessive or undue appreciation of rupee, RBI converts the foreign capital inflows in rupee terms and inducts equivalent domestic currency of money supply causing the money supply in the economy to increase. Likewise, with an outflow of the foreign capital, the liabilities side of the RBI's balance sheet decreases causing a *depreciation* of rupee. Once again, to stabilise the money supply, RBI exchanges rupee for dollars (causing the money supply in the economy to decrease) to balance the assets with liabilities. The mechanism of foreign capital inflows, thus, virtually forces RBI to infuse domestic currency into the market. The foreign investors need rupees to invest in India. The foreign currency brought in by those investors (and deposited with the RBI) gets them equivalent amount of Indian rupees. On the other hand, when a foreign investor liquidates his holdings in India, he first gets payment in rupees. These are then deposited with RBI and exchanged for foreign currency which is allowed to be repatriated. This function of the central bank is called as the role of 'exchange rate stability' on which you will study more in Section 1.4 of this unit.

1.3 MONETARY POLICY INSTRUMENTS

The RBI regulates the entire banking system and the money market in India. For this, it is vested with the authority to exercise certain quantitative and qualitative measures in order to regulate the money supply. Quantitative measures are employed to modulate the credit creating capacity of the banks while the qualitative measures are used to direct the credit flow towards the desired sectors of the economy (called priority lending policy). The Sukhmoy Chakrawarti Committee (1980) added a new dimension to the role of the RBI by stressing that besides its hitherto assumed roles (i.e. striving for achieving price stability, economic growth, equity and social justice), the RBI should also strive for the creation of new monetary and financial institutions for an orderly development of the Indian money market. This thus became the fifth objective of the RBI's monetary macroeconomic role. The roles of RBI has proliferated since the 1990s on which you will study in Section 1.5 of this unit.

RBI controls money supply in the economy through various policy tools. Among other things, these tools principally target the credit creation capacity of the banks. For this, it prepares a monetary policy framework and reviews it periodically. Regulation of money supply is a twofold process viz. (i) regulating cash in circulation and (ii) regulating credit. For the purpose of the former, the RBI issues new currency to meet the growing demand for money keeping in view the growth rate and the inflation rate (both expressed in percentages) in the economy. For the latter, RBI controls supply of credit money through various policy measures like (i) bank rate, (ii) cash reserve ratio (CRR), (iii) statutory liquidity ratio (SLR), (iv) open market operations, etc. Some of the other measures adopted by the RBI are: credit rationing, selective credit control, liquidity adjustment facility and moral suasion. Through a combination of these measures, the RBI regulates the overall money supply in the economy with only the minimum necessary direct intervention to alter the volume of currency in circulation.

1.3.1 Reserve Ratios

The 'cash reserve ratio' (CRR) is a major and important tool employed by the RBI to regulate money supply. Under the policy of cash reserve requirement, banks are required to keep a certain fraction of their aggregate deposits in the form of liquid cash with the RBI. CRR requirements are mandatory for all banks like scheduled commercial banks, non scheduled banks, cooperative banks and the regional rural banks. CRR directly affects the lending capacity of the banks in a very effective manner. RBI imposes penal interest rate on banks which fail to comply with the CRR norms. As noted in equation (1.3) above, the value of the deposit multiplier (D) is the inverse of the CRR (x). Thus, if CRR is 20 percent the value of the deposit multiplier is 5.

Like the CRR, another important tool employed by the RBI is the 'statutory liquidity ratio' (SLR). SLR is the fraction of the cash in the hands of the banks after meeting the CRR obligations. Thus, while CRR is the primary reserve requirement, SLR is the secondary reserve requirement. SLR requirement can be met by the banks either in the form of cash, gold, government securities or any other approved security. SLR thus not only helps in regulating the banking credit creation but also ensures solvency of the banking system. While there is no provision of imposing monetary penalty for the violation of SLR norms, defaulting banks' access to RBI's refinance facility would be restricted.

1.3.2 Bank Rate

Bank rate is that rate at which RBI re-encashes (buy back) the bills of exchange and promissory notes. It is also the rate at which loans and advances are extended to the banks [i.e. SCBs, cooperative banks, state finance corporations (SFCs) and others]. It is thus basically an interest rate at which RBI gives loans and advances to the banks and financial institutions. The interest rate charged is calibrated to control the money supply even though it is basically meant to cover the cost of borrowed funds. When RBI raises the bank rate, banks and financial institutions also increase their lending rates. As a consequence, demand for loans and advances decrease. Thus, money supply in the economy falls through reduced credit money.

1.3.3 Repo and Reverse Repo Rates

Repo rate is that rate at which RBI lends money to the commercial banks for any shortfall in their funds. It is thus a short term lending rate of the RBI.

Repo rate is used as a tool to control inflation in the short run. RBI frequently adjusts the repo rate to control inflation. By increasing the repo rate, RBI increases the cost of lending of the banks. Reverse repo rate (RRR) is the opposite of repo rate. RRR is the rate at which RBI borrows money from the commercial banks to wipe out excess funds in their hands. It is a short term borrowing rate of the RBI. RBI frequently adjusts the RRR to control money supply. By increasing the reverse repo rate, RBI incentivises the commercial banks to part with their excess funds to it. This reduces the money available with the banks thereby restricting its credit potential and consequently reducing the supply of money in the economy.

Besides the above instruments, RBI can control money supply through 'open market operations'. Under this, RBI carries out 'sale and purchase' of government securities. When banks purchase securities from RBI, their cash reserve position decreases. This reduces their ability to create credit. On the other hand, when banks sell securities their cash reserve position increases. Thereby, their capacity to create credit is enhanced. Until recently, open market operations as a policy tool was not used by RBI but was mainly used for management of government debt. Since early 1990s, open market operations are being used more (through repos) for maintaining exchange rate stability. There are also other policy measures such as rationing of credit, margin requirement on loans and moral suasion. For instance, RBI being the lender to other banks, can adopt the policy of 'credit rationing' to reduce money supply. This means it can deny loans to specified category of banks or can put a ceiling (quota) on the loans extendable to the banks. It can also impose an upper limit on the loans to industry by the banks or set a higher margin requirement on the collateralised lending by the banks or can direct banks to keep a higher prescribed margin on the collateral security for granting loans to borrowers. Lastly, RBI can resort to 'moral suasion' to sensitise banks to refrain from excessive lending.

Check Your Progress 1 [answer within the space given in about 50-100 words]

1) State the major macroeconomic objectives of monetary policy.

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2) What is meant by 'monetary base' of an economy?

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3) What is 'deposit multiplier' (DM). What is its relationship with CRR?

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4) Does 'high powered money' influence credit creation? How?

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5) When does the RBI resort to applying the 'quantitative measures'? How does this differ from the 'qualitative measures' adopted by the RBI?

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6) When does the RBI resort to applying the 'quantitative measures'? How does this differ from the 'qualitative measures' adopted by the RBI?

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7) For regulating the cash in circulation in the economy, which two factors are kept in view by the RBI?

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8) State the two important 'reserve ratios'. In what respect are they helpful?

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9) Distinguish between repo and reverse repo rates. How are they useful?

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10) Mention the various other measures which are employed by the RBI to control the money supply in the economy.

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1.4 OBJECTIVES OF MONETARY POLICY

The process through which monetary policy affects the different sectors in the economy is known as 'monetary transmission mechanism'. It works on the fundamental premise that money is not neutral in its effect on investment demand and GDP. It implies that, under flexible supply conditions (below full employment), expansion in the supply of money always augments economic growth. Therefore, effects of changes in the monetary sector gets transmitted to the 'real sector' through rate of interest. In essence, 'monetary sector' and the 'real sector' are integrated through the 'interest rate'.

Monetary transmission mechanism works to serve both the expansionary as well as the contractionary objectives of monetary policy. For the former, when demand for the currency increases in the economy the commercial banks approach the RBI with securities. RBI issues new currency in exchange for their securities. This stimulates the supply for loanable funds causing the interest rate to fall. A fall in the nominal interest rate, in turn, leads to an increase in private investment and consumption expenditure both by firms and consumers. This results in a rise of aggregate demand in the economy. Thus, under the assumption of flexible supply conditions and less than full employment, any increase in aggregate demand results in an increase in the GDP. On the other hand, during a contractionary phase, a reduction in the money supply leads to a rise in the nominal interest rate. This in turn decreases the borrowings for investment (and consumption) inducing the people to save more. This causes a fall in the aggregate demand in the economy leading to a lower GDP and reduced employment level (recall the IS-LM analysis).

Thus, the RBI can alter the money supply in the economy by calibrating the 'interest rate'. Changes in the interest rate affect the investment and consumption behaviour of both the firms and the consumers causing either a rise or a fall in the aggregate demand (for goods and services) with the consequent impact on the GDP and employment levels.

1.4.1 Price Stability

One of the important objectives of monetary policy is to promote economic activities while maintaining stability in prices. In an integrated global economy, booms and recession originating in one part of the world easily spread to other parts. For instance, financial meltdown in the US in 2008 quickly spread globally. Hence, one of the added tasks of the monetary policy in the new world order is not only to provide an adequate cushion but also be more adaptive and responsive to external shocks. This requires that the monetary policy mechanism should be capable of coping with the shocks of both the low and high business cycle periods viz. recession and hyper inflation. Recession is a business cycle contraction which slows down economic activities and adversely impact real GDP, employment, industrial production and wholesale and retail sales. It has been observed in the past that an imported recession has minimum impact on Indian economy due to the presence of a large informal sector, large public sector and a domestic demand cushion. An easy monetary policy, supplemented by the expansionary fiscal policy, helps to reduce nominal interest rate, encourage consumption demand and investment demand and discourage savings. This would help in raising the aggregate demand and stabilise prices bringing the economy out of the recession.

Boom is a phase of business cycle expansion in which aggregate demand is persistently pushed up by the market expectations. Effects of boom on the real sector depend upon the level of employment and the responsiveness of the aggregate supply to the demand. A boom in an economy, already at full employment, causes inflation. It impacts more on prices than on GDP and employment due to the weak response of aggregate supply to aggregate demand. A tight monetary policy, supplemented by contractionary fiscal policy, is required to combat the boom in an economy. Tight monetary policy increases nominal interest rate which reduces consumer demand, promotes savings and discourages investment demand. The overall effect works to reduce aggregate demand, stabilise prices and eliminate boom.

1.4.2 Exchange Rate Stability

An important function of the monetary policy is to protect exchange rate from shocks and in the process prevent volatility (i.e. appreciation or depreciation) in domestic currency from speculative actions. This is particularly important in the era of managed floating exchange rate under which a trade-off exists between exchange rate stability and macroeconomic objectives of unemployment and inflation. Hence a balance needs to be maintained. Monetary policy cannot be an effective tool under fixed exchange rate and imperfect capital market conditions restricting the liberalised mobility of capital. It can be better applied under the floating exchange rate system in which response to changes in interest rate would adequately influence the economy for the desired reorientation. However, monetary policy can still be used to minimise exchange rate volatility by balancing the money supply from capital inflows by selling bonds of equal value in the money market. Such a balancing measure (called a sterilisation policy) is aimed at mopping up the additional supply of money caused by foreign capital inflows. Monetary policies are thus useful in reducing the risk of capital flight sparked by the speculations of depreciation of currency.

1.4.3 Economic Growth

By adopting an easy monetary policy, aggregate demand can be increased by reducing nominal interest rate in the economy. This is because, as interest rate falls, both private investment and consumption expenditure increase leading to an increase in the aggregate demand in the economy. Under the assumptions of less than full employment and with induced capital formation, the economy grows faster. In addition, monetary policy can also create new financial institutions which can tap savings in the economy leveraging them in productive sectors to achieve growth.

1.4.4 Export Promotion, Employment Generation and Equity

By devaluing the rupee exchange rate, monetary policy can be used to promote exports and discourage imports. As a consequence, imports become expensive and exports become cheaper helping reduce the current account deficit. By extending cheaper loans to exporters, monetary policy can help boost exports. An easy monetary policy, by raising aggregate demand, can increase employment level through multiplier effect. Further, by adopting the policy of priority lending (which is helping the weaker sections in the society through cheaper and easy loans), the poor and the marginalised can be helped in setting up self employment ventures. Such measures can help reduce inequality in the economy.

1.5 CHANGES IN THE MONETARY POLICY MECHANISM IN INDIA

Monetary policy underwent significant transformations since the mid-1990s and more aggressively during the years 2000-2005. Recent reforms of post-2000s became essential to address the new realities and challenges emerging from global economic integration and greater market orientation. With this, monetary policy stance witnessed a clear shift from direct intervention to indirect intervention. Greater reliance had to be placed on approaches like: (i) open market operations (OMOs), (ii) liquidity adjustment facility (LAF), (iii) market stabilisation scheme (MSS) and (iv) establishment of 'marginal standing facility' (MSF). OMOs was earlier outlined in Section 1.3. In this section, we will briefly note the importance and functioning of the other three.

1.5.1 Liquidity Adjustment Facility (LAF)

Liquidity Adjustment Facility scheme was launched by RBI in the year 2000 and was subsequently revised in the year 2004. LAF is a short term liquidity management technique. Under this, RBI sells and purchases government securities at repo rate and reverse repo rate respectively to absorb or inject money into the economy on short term basis. RBI periodically revises these rates in its monetary policy reviews. It is thus a day to day or emergent lending and borrowing facility for banks to meet their short term liquidity needs. LAF operations, combined with open market operations and bank rate changes, have since become the major technique of monetary policy in India.

1.5.2 Market Stabilisation Scheme (MSS)

RBI launched the 'market stabilisation scheme' in 2004 to withdraw excess liquidity from the money market by selling government bonds. MSS was meant to mop up excess liquidity arising from the RBI's purchase of foreign currency in order to protect the exchange rate in times of excess inflow of foreign capital into the country. Since such inflows can appreciate rupee causing current account deficit to widen, the scheme was meant to act as the market stabiliser. Under this scheme, RBI purchases dollars (or any other currency) so as to neutralise the effect of excess liquidity created in the economy. The objective is achieved by the selling of bonds to absorb the excess liquidity. As mentioned above, this is also referred to as 'sterilisation'.

1.5.3 Marginal Standing Facility (MSF)

Marginal Standing Facility is a new window created by RBI in 2011 [under the Liquidity Adjustment Facility (LAF)] for overnight lending of funds to banks. Banks can borrow overnight funds at MSF rate (from the RBI) against approved government securities. This is thus a kind of emergency lending for banks, made at a rate higher than the repo rate, to counter overnight volatility in the interest rates. Before MSF, inter-bank borrowing was the only way to meet overnight funds requirement. The proliferation of economic activities had over the years caused sharp fluctuations in short term (over night) inter-bank lending rates. Thus, the overall idea behind MSF is to reduce overnight volatility in inter-bank lending rates.

In more recent years (i.e. since 2015), a new Monetary Policy Framework Agreement (MPFA) has shaped the stance of monetary policy in India. As per this, the RBI will focus on ensuring that inflation remains moderate to achieve a CPI (consumer price index) linked inflation target of 6 percent by January 2016 and 4 percent by the end of 2017-18. The target beyond 2017-18 is defined in terms of a tolerance band of +/- 2 percent around 4 percent. Inflation, based on all India CPI was 5.9 percent during 2014-15 and (except for a short stint of slightly above 6 percent in the year 2016) has remained below 6 percent since then. It was at a record low level 1.54 percent in June 2017. Thus, MPFA, since its inception, has succeeded in lowering the CPI inflation rate effectively.

Check Your Progress 2 [answer within the space given in about 50-100 words]

1) What is the basic premise on which 'monetary transmission mechanism' is based?

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2) What are the characteristics of a period of recession? How does monetary policy help cope with this?

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3) Does an economy like India face serious impact from global recession? Advance reasons for your stand.

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4) How is a situation of boom different from recession? What monetary policy stance is helpful to deal with a situation of economic boom?

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5) By meeting out which broader objective of monetary policy, are the situations of both recession and boom managed from the policy front?

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6) What is meant by a 'sterilisation measure' in the context of monetary policy?

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7) In what manner the objective of economic growth achieved by monetary policy?

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8) How can monetary policy be effective in reducing inequality in an economy?

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9) What is the primary objective served by 'liquidity adjustment facility'? Which are the other recent measures introduced into the monetary policy approaches in India?

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10) What is a more recent (post-2015) change in the monetary policy of India? What particular objective has this served?

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1.6 LET US SUM UP

Monetary policy aims at achieving the broad macroeconomic objectives of ensuring adequate money supply to aid an optimum level of economic growth and maintain exchange rate stability. Various measures like reserve ratios, bank rate and repo and reverse repo rates are traditionally employed to meet these objectives. However, in the post-liberalisation phase to meet with the volatility of FDI inflow/outflow, among others, new measures like liquid adjustment facility, market stabilisation scheme and marginal standing facility were introduced. More recently, a mechanism called MPFA (monetary policy framework agreement) was introduced by which the RBI has been successful in keeping the consumer price index linked inflation rate well within the targeted range of 4-6 percent.

1.7 KEY WORDS

Inflation : It is a sustained rise in the general price level in an economy over a period of time. Inflation debases the value of money i.e. it reduces the purchasing power of money. It means that same amount of money can now buy a lesser quantity of goods and services in the market than at an earlier point of time.

Price Stability : Refers to the absence of sustained fluctuations in the general price level in an economy. In other words, it is the absence of boom and recession.

Real Sector and Monetary Sector	:	Real sector is that part of an economy where we study variables measured in physical quantities (e.g. agricultural/industrial production, GDP, capital stock, etc.). Monetary sector of an economy deals with variables expressed in terms of money (e.g. price level, exchange rate, interest rate, etc.).
Promissory Notes	:	A promissory note is a financial debt instrument in which one party promises in writing to pay the amount due to the other party at a predetermined future date or on demand under specified terms and conditions.
Bills of Exchange	:	Are negotiable financial instruments like a bond or a promissory note. It is an unconditional written order, addressed and signed by one party assuring another party to whom it is addressed, to pay on demand immediately or at a fixed or at a determinable future time, a certain sum of money either to the specified person or to the bearer.
Government Securities	:	These are government debt instruments like bond and treasury bills. These are also called 'guilt edged securities' because they are risk free. They are issued by the RBI on behalf of the government to finance fiscal deficit. They are money market instruments to raise loans for the central government.
Government Bond	:	A bond is a financial instrument with a face value and a specified rate of return on it. These are issued only by the central government to borrow money from the financial market. Government bonds are also called sovereign bonds. They are always denominated in domestic currency like 'rupee bond'. The government does not ordinarily default on the bond but it can repudiate to pay back. When a government is likely to default on bond the situation is called as 'sovereign debt crisis'.
IS-LM analysis	:	Developed by Hicks and Hansen, it is the synthesis of real sector and monetary sector in an economy. IS or investment-saving schedule is the locus of the different combinations of real interest rate and GDP at which goods market is in equilibrium. On the other hand, LM (liquidity preference and money supply) is the locus of various combinations of GDP and real interest rate at which money market is in equilibrium. So, IS-LM model combines goods market with money market simultaneously showing general equilibrium in the goods market and money market.

Exchange Rate	**:**	Exchange rate is the price of one currency expressed in terms of other currency. It is a relative price of currencies.
Floating Exchange Rate	**:**	It is a system which allows the exchange rate to be determined completely by the forces of demand and supply in the market with central banks not intervening directly.
Managed Floating Exchange Rate	**:**	It is a combination of fixed and floating exchange rate systems. Under this, central banks allow the currency exchange rate to fluctuate within a predetermined band. Central banks frequently intervenes in the foreign exchange markets to stabilise exchange rate.
Currency Appreciation and Currency Depreciation	**:**	Currency appreciation and currency depreciation are foreign exchange market phenomena under the floating exchange rate system. When the value of one currency in terms of the other currency increases in the foreign exchange market it is called currency appreciation. When the value of one currency in terms of the other currency decreases in the foreign exchange market it is called currency depreciation.

1.8 SOME USEFUL BOOKS AND REFERENCES

1) Bhole L. M. & J. Mahakud (2009). *Financial Institutions and Markets,* 5th Edition, Tata McGraw Hill Publishing Company Ltd.

2) Krugman P. R., M. Obstfeld & M. J. Melitz (2018), *International Economics: Theory and Policy,* 10th Edition, Pearson India.

1.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) (i) ensure the money supply required for the economic expansion (i.e. increase output), (ii) keep the prices stabilised (i.e. control inflation) and (iii) maintain exchange rate stability (i.e. ward off excessive appreciation or depreciation of domestic currency).

2) It is the most liquid form of money consisting of three components viz. currency held by the public, demand deposits or current accounts held by the banks and other deposits kept with the RBI.

3) DM is a multiple of cash deposits which determines the extent of credit money that can be created by the SCBs. DM and CRR are inversely related i.e. higher the CRR, lower is the level of credit money.

4) Yes. If D denotes total deposits, and b and x are the 'fraction of total deposits which the public wants to hold in cash and the CRR respectively, then the 'high powered money' is related as: $H = D * (b + x)$ [$(b + x)$ is the DM].

5) Quantitative measures are employed to regulate the credit creation by the banks. Qualitative measures are employed to direct the credit flows towards the desired sectors and segments of the economy/population.

6) The four conventional roles are: price stability, economic growth, equity and social justice. The additional role added is one of creating new monetary and financial institutions for an orderly development of money market.

7) Economic growth and inflation, both expressed as percentages.

8) CRR and SLR. The former is an obligation of keeping a certain amount of liquid cash with the RBI (which is determined as a 'fraction of the aggregate deposits' with the banks). SLR is 'total liquid resources held by the banks minus CRR'. It is the secondary reserve requirement (the primary one being the CRR). While CRR influences the effective lending capacity of the banks, SLR besides regulating the banking credit also ensures the 'solvency of the banking system'.

9) Repo rate is the rate of interest at which RBI extends loans to commercial banks for meeting their short term fund needs. It is useful as a tool to control inflation in the short term. Reverse repo rate (RRR) is the rate at which the commercial banks can park their excess cash with RBI. RRR is useful in controlling the money supply (e.g. by increasing RRR, RBI is incentivising the banks to part with their excess funds).

10) Open market operations, rationing of credits, margin requirement on loans and moral suasion.

Check Your Progress 2

1) That money is not neutral and as long as the economy is working in a state of 'less than full employment', infusion of money into the economy always results in economic growth or growth in GDP.

2) It refers to a business cycle contraction characterised by an overall slow down in economic activities adversely impacting all macroeconomic indicators like GDP, income, employment, production and prices. A liberal monetary policy can help lower the interest rate thereby giving scope for stimulating consumption and investment demand.

3) Economies like India are characterised by the presence of a large informal sector and huge domestic demand. These characteristics provide a cushion to cope with non-domestic recession.

4) A boom in an economy causes high inflation in an economy already at full employment. Adverse impact of boom is experienced due to inadequate response of supply. To take care of the adverse consequences of boom, what is needed is to improve the supply side response. A tighter monetary policy, coupled with a contractionary fiscal policy, can help overcome the adverse consequences of a period of boom.

5) The objective of price stability is sought to be achieved by the calibrated policy stance of both monetary and fiscal dimension. This helps restore aggregate demand to the required optimum thereby achieving stability in prices.

6) It is a balancing measure aimed at mopping up the excess foreign capital inflow. The balance is achieved by the selling of bonds, minimising speculative devaluation of currency.

7) By increasing aggregate demand as a consequence of lowered interest rates. Lower rates of interest reduce cost of investment and promote creation of additional productive capacities and jobs. Besides this, monetary policy can also help create new financial institutions to tap savings and aid productive growth in the economy.

8) Through reduced interest rates spiralling into promotion of exports and employment creation on the one hand and by advancing priority lending to help establish self employment ventures to assist the poor and marginalised sections on the other.

9) Meet the short term or over night liquidity needs by extending lending and borrowing facility to the banks. Open market operations, market stabilisation scheme and marginal standing facility are the other recently introduced measures for indirect intervention by the RBI in the financial market operations.

10) Introduction of new 'monetary policy framework agreement' (MPFA) in 2015. The agreement aims at bringing the CPI linked inflation to 4 percent by 2017-18 and thereafter maintain it in a bank of +/- 2 percent around 4 percent. The policy has served its purpose in keeping the CPI interest rate low i.e. within the 4-6 percent range over the years 2015-18.

UNIT 2 FISCAL POLICY*

Structure

2.0 Objectives

2.1 Introduction

2.2 Types of Fiscal Policy

    2.2.1 Implications of Fiscal Policy

2.3 Brief Review of Fiscal Policy in India

    2.3.1 Fiscal Policy in Post-1990s

2.4 Instruments of Fiscal Policy

    2.4.1 Taxation

    2.4.2 Expenditure

    2.4.3 Debt

2.5 Fiscal Deficit

2.6 Let Us Sum Up

2.7 Key Words

2.8 Some Useful Books and References

2.9 Answers/Hints to Check Your Progress Exercises

2.0 OBJECTIVES

After reading this unit, you will be able to:

- state the objectives of fiscal policy;
- outline the two major types of fiscal policy along with its implications;
- review the fiscal policy followed in India since independence with an emphasis on changes introduced in it during the post-reform years;
- discuss the instruments of fiscal policy; and
- differentiate between the terms fiscal deficit, revenue deficit and primary deficit;

2.1 INTRODUCTION

Fiscal policy is a policy of the government related to taxes, government spending and borrowings of the governments for attaining stability and desired level of growth in an economy. The impact of the fiscal policy on any economy is huge. They can be gauged with the help of indicators like: (i) level of national income, employment and inflation, (ii) level of saving and investment and (iii) the position of balance of payment (BoP).

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In India, the central and state governments combined Tax-GDP ratio has increased from 6.0 percent in 1950-51 to 17.2 percent in 2015-16. Over the years 2006-07 to 2017-18, this ratio has hovered between 10-12 percent (for developed countries this ratio is higher ranging from 20 percent in Russia to 48 percent in France). Non-development expenditure of the central and state government are mainly driven by expenditure on defence, interest payment and subsidy while development expenditure is driven by railways, posts and telecommunication, social and community services, agriculture and allied activities, industries and minerals, power, irrigation and flood control, transport and communication and public works. Fiscal policy has many objectives. Specifically, it aims at: (i) mobilising resources through taxes and borrowings; (ii) maintain price stability; (iii) provide incentives for private sector growth; and (iv) reduce income and wealth inequality.

2.2 TYPES OF FISCAL POLICY

Keynes viewed fiscal policy as a tool by which government can effectively intervene to achieve the desired growth (or control) in important variables like income, employment, price, etc. in an economy. To achieve this, the fiscal policy is used in one of its two types viz. (i) expansionary fiscal policy; and (ii) contractionary fiscal policy.

Expansionary fiscal policy aims at either increasing the government expenditure or decrease the tax rates (or a combination of both) so as to boost the aggregate demand in the economy. It is particularly used at the time of economic recession. Expansionary fiscal policy however has the effect of reducing private investment because it results in higher interest rate. Contractionary fiscal policy aims at reduction in government expenditure or increase in tax or combination of both for reducing aggregate demand in an economy at the time of high inflation. This can be better understood with the help of following National Income Identity proposed by Keynes.

$$Y = C + b(Y - tY) + TR + I + G + NX \qquad (2.1)$$

where, Y = GDP, C = autonomous/subsistence consumption, b = marginal propensity to consume ($\Delta C/\Delta Y$), ($Y - tY$) is disposable income or induced consumption, TR is 'transferred funds' (i.e. from central to state governments on account of states' share in central revenue, grants in aid, etc.), I is investment, G is government expenditure and NX is net export. Any change in fiscal policy has significant impact on the government's budget through its effect on all the components reflected in Equation (2.1) above. Normally, expansionary fiscal policy results in fiscal deficit for the government. It is a situation where government income is lower than its expenditure.

2.2.1 Implications of Fiscal Policy

Tax policies impact the level of aggregate demand through changing levels of economic activities which are sensitive to changes in interest rate. While the imposition of higher tax reduces aggregate demand it also lowers the level of economic activities through reduction in private investment. In addition, it impacts the government's social sector expenditure. There are instances where countries experience increase in government expenditure which could not be financed by tax revenues (or other sources of government income). In such situations, government is forced to borrow from the market. As a result of such borrowings, it has to devote resources in servicing the debts. Besides these economic implications, fiscal policy also has significant political implications. For instance, a change in fiscal policy could result in: (i) either increase/decrease in government expenditure or (ii) increase/decrease in tax burden to individuals/firms or both. Such changes resulting in pleasure or displeasure could show up in voters preference to the incumbent government driving them out of power at times. A good fiscal policy should therefore be prudently coordinated with monetary, debt and credit policy for effective results. It should have a clear cut road map of financing fiscal deficit and use of surplus resources.

Indian economy is a developing economy which continues to be characterised by adverse indicators (e.g. poverty, illiteracy, inequality, etc.) of economic development. It has a federal government system with its Constitution conferring the power of taxation and expenditure to both the central and the state governments. The Constitution mandates governments to submit proposals of income and expenditure for each financial year to their legislative bodies for debate and approval (known as budget). While the central government is concerned with the issues related to national interest like defence, PSUs, foreign trade, etc. the state governments are tasked to maintain law and order, address issues related to agriculture, public health, etc. Some areas like education, forest, inflation, social and economic planning fall under the concurrent list providing scope for both the central and state governments to operate. There is also a 3rd layer of government at local level (like municipal corporations, zilla parishads) with power to impose taxes for meeting the requirements of public welfare at their level.

2.3 BRIEF REVIEW OF FISCAL POLICY IN INDIA

A major policy decision in the direction of economic development in India was the establishment of the Planning Commission in 1950. Guided by socialist principles, its principal thrust during the first few decades of its establishment was to set up and strengthen the public sector base in India. The main aim of fiscal policy of that time was also therefore to transfer resources from private sector to the public sector so as to meet the consumption and investment requirements of public sector units. The other objectives of fiscal policy was to reduce income and wealth inequalities by way of taxes and 'transferred funds' to state governments so as to promote a balanced regional growth in the country.

The main source of government revenues being direct and indirect taxes, personal and corporate taxes were initially kept very high. As a matter of fact, even in 1973-74 (after 25 years of independence), the personal income taxes were in 11 tax-income slabs with rates monotonically increasing from a low of 10 percent to a high of 85 percent. The policy was similar in the case of corporate taxes where the system was one in which profit was taxed in the hands of the companies and dividend was taxed in the hands of the shareholders. The corporate tax slabs varied from a high of 45 percent to 65 percent. The Direct Taxes Enquiry Committee (1971) described the impact of the tax system in 1971 as 'confiscatory' and recommended tackling the large scale tax evasion (identified as owing to the high tax rates) by a reduction in the *marginal rate of direct taxes* to 70 percent (which was 97.5 percent before for persons with income of above rupees 2 lakhs per year including the surcharge of 15 percent levied). In 1976-77, this marginal rate of taxation was further reduced to 66 percent. A major simplification and rationalisation in this respect was achieved in 1985-86 when the number of tax slabs was reduced to 4 and the highest marginal tax rate reduced to 50 percent.

The major components of indirect taxes are excise duty, service tax and customs duties. Of all these, the central excise duty was a dominant component of indirect tax. Most of the indirect taxes were imposed on inputs of manufactured goods resulting in high price of final goods. To curtail the cascading effect, the Indirect Tax Enquiry Report of 1977 introduced a Manufacturing Value Added Tax (MANVAT). Under this, input tax credit was begun to be given to manufactures. Later, in 1986, a Modified Value Added Tax (MODVAT) was introduced. This however covered only some selected goods. Customs duty, imposed on imports with a view to promote the policy of imports substitution, which had prevailed right from the early phase of economic development in the post-independence period, continued till the 1980s. Towards the middle of 1980s, in 1985-86, the government reduced the tariffs on imported goods and also removed quantitative restriction on imports.

2.3.1 Fiscal Policy in Post-1990s

While the pre-1990s policies was aimed at import substitution, the economic policy of 1990s was pro market. Personal income tax brackets were reclassified into three parts with 20, 30 and 40 percent in 1992-93. This was further reduced to 10, 20 and 30 percent in 1997-98. Wealth tax (which was around 5 percent before) was reduced to 1 percent. Under indirect taxes, the MODVAT credit was expanded to cover most of the commodities by 1996-97. Three rates of excise duty were merged into one single rate and was renamed as Central Vat (CEVAT) in 2000-01. Customs duty on non-agricultural goods which was more than 150 percent were progressively reduced from 40 percent in 1997-98 to 15 percent in 2005-06. A service tax was introduced in 1994-95 and it has since been steadily expanded over the years.

While there were significant changes in the central taxes in the post-reform period, there were not adequate reforms in the tax policies of state governments during the 1990s. In the post-2000 years, as a part of simplification of state sales tax, a Value Added Tax (VAT) was introduced in 2005 in 21 states. Under this, VAT credit were given to tax paid on inputs. The administrative design of the VAT was such that, due to reduction in tax evasion, the revenue of the state governments increased. However, the system was not effective in the creation of a smooth nationwide market. The idea that a single Goods and Service Tax (GST) will be helpful in this direction got mooted for the first time in the year 2000.

A major change in the taxation policy was seen by a significant reforms in the structure of central government revenue. This change was evident in a structural shift from the relative shares of indirect and direct taxes. For instance, around 54 percent of total revenues of the central government came from indirect taxes in 1995-96. This was reduced to 32 percent in 2009-10. Thus, in terms of the relative shares of direct and indirect taxes in the total taxes collected (i.e. direct plus indirect), the share of direct taxes increased by 22 percent over the period 1996-2010 [i.e. from 46 percent to 68 percent]. Two major fiscal challenges that had to be faced by the end of 2010 are: (i) the World Economic Recession of 2008 (which resulted in considerable exchange rate instability and decline in growth rate consequent to decline in aggregate demand and decline in exports) on the external front; and (ii) rural farm loan waiver scheme and expansion of Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) on the domestic or internal front. There was however relatively less effect of the world economic recession on the Indian economy due to factors like: stringent financial market regulation, adequate foreign exchange reserve, big domestic market and timely fiscal policy intervention. GDP growth which was an annual average of 5.7 percent over the two decades period of 1981-2000, increased to an annual average of 7.2 percent during the period 2001-2012. A central GST Act was finally implemented all over the country in the year 2017.

Check Your Progress 1 [answer within the space given in about 50-100 words]

1) What are the objectives of fiscal policy?

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2) What is a limitation of the expansionary fiscal policy?

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3) State some of the important economic implications of a fiscal policy.

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4) In respect of direct tax (or personal income tax), how would you describe the prevailing situation in India till nearly 25 years after its independence?

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5) Between the 1970s and the 1980s, how was rationalisation in direct taxes brought about in India?

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6) What were the major changes introduced in the fiscal policies of 1990s?

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7) What would you describe as a 'structural shift' in the fiscal policy of India and in what time span was this achieved?

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8) What were the two major factors which posed fiscal challenge towards the end of 2010? What factors contributed to keeping the adverse impact due to these to a minimum for the Indian economy?

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2.4 INSTRUMENTS OF FISCAL POLICY

Since fiscal policy affects the income level by impacting the level of economic activities and level of aggregate demand in an economy, government often borrows and invest in order to maintain or accelerate the economic buoyancy in a country. From this point of view, the aim of fiscal policy can be stated as to manage the level of aggregate demand by calibrating the price and income levels in accordance with the requirements of the economy. This is achieved by adopting the three instruments of fiscal policy viz. (i) taxation, (ii) expenditure (i.e. transfer of funds to state governments and direct consumption of government), and (iii) borrowing or debts.

2.4.1 Taxation

The principal source of government revenues are taxes. They can be broadly classified as: (i) direct taxes and (ii) indirect taxes. Personal and corporate taxes are the main form of direct taxes levied by the central government. Indirect taxes are levied on goods and services and are paid by their end users. Examples of indirect taxes are: excise duty, service tax, customs duty, etc. Central excise duty is an important indirect tax levied on the manufacturing sector. Local bodies impose property tax which is a kind of direct tax.

In the period immediately after India attained its independence, the tax system in India was so structured as to transfer resources from private sector to public sector dominated industrialisation process and to cover the cost of social welfare schemes. The share of indirect taxes in total revenue collection of India was higher than direct taxes. Such indirect taxes distort the resource allocation in the economy as their burden falls disproportionately on different groups of consumers (i.e. those who buy goods with lower elasticity of demand are also burdened with the same amount of tax as others). In other words, higher indirect taxes results in a higher burden of taxes on people with relatively low incomes. Such a policy stance, followed during the decades of 1950-80 kept the growth rate of Indian economy modest (3.5 percent average annual over the period 1950-80). The objective of taxation should be such that the proportion of direct taxes collected is more than the indirect taxes. Gross tax revenue being the sum of corporate tax, personal income tax, customs duties, excise duties and service tax, the focus on increasing the direct tax ratio should aim at expanding the base of corporate and personal income tax. Direct Tax-GDP ratio of the union government has increased from 2.3 percent in 1991-92 to 5.6 percent in 2015-16. Indirect Tax-GDP ratio has correspondingly come down from 7.4 percent in 1991-92 to 4.6 percent for 2015-16. The growth rate of the Indian economy has also increased during the years of late 1990s to the years in post-2000s (as stated above it was 5.7 percent over 1981-2000 and 7.2 percent during 2001-2012). The correlation between economic growth and revenue generation through tax collection (with an emphasis on rising share of direct taxes or lowered share of indirect taxes) is thus evident.

2.4.2 Expenditure

Central government's budgetary expenditure can be broadly divided into its own expenditure and transferred funds to state governments and the union territories. Total central government expenditure is classified into: (i) revenue expenditure and (ii) capital expenditure. Expressed as percentage of GDP, total expenditure of central government in recent years (2014-18) has been about 13 percent of which about 11 to 12 percent (i.e. more than 85 percent of total) is of revenue expenditure and the balance of 1.5 to 2 percent only (i.e. a mere 15 percent of total expenditure) is capital expenditure. Thus, revenue expenditure (which is spent on items like salaries, pensions, subsidies and interest payments) takes up the bulk of central government's expenditure. All grants given to states and union territories are treated as revenue expenditure although out of these grants some part is used for creation of capital assets. The objective of efficient government expenditure requires that over time capital expenditure should increase and revenue expenditure should come down.

2.4.3 Debt

If the total revenue of government is not enough to cover its total expenditure, then government borrows from market by issuing bonds to investors to make up for the deficit. If the size of debt is small in relation to tax revenue, government obligation in terms of debt service and repayment of debt will be low. However, if size of debt is big and revenue collection is not sufficient to service debt, there is the possibility that government may default in the repayment of its debt. In case of high risk of default, interest rate on bond increases to cover the additional risk for investors.

Debt-GDP ratio is the ratio of a country's public debt to its GDP. Debt-GDP ratio of India was around 68.5 percent (of GDP) in 2017. Average debt-GDP ratio of India over the period 1991-2017 is 73 percent [it was highest (84.2 percent) in 2003 and lowest (66 percent) in 1996]. If a country is able to pay interest on its debt without borrowing or compromising on its economic growth, it is considered a stable scenario. Debt-GDP ratio is used as a tool to gauge the ability of a country to service its present and future debts. Empirical studies on the relationship between debt and GDP have established that if the debt-GDP is more than 90 percent, there will be a negative impact on the economic growth of that country (Reinhart-Rogoff, American Economic Review, 2010). However, there are countries, particularly developed countries, with higher debt-GDP ratio for long time (e.g. Japan above 200 percent, USA above 100 percent). But the size of the economy and their total revenue are quite adequate to service and repay their debts. Further, there are some specific features of these economies which is sustaining such a high debt-GDP ratio. For instance, most of the debt of Japan is owned by the Japanese public. Further, the Bank of Japan plays a significant role by purchasing its government bonds. Ownership of government debt in USA is also similar with two-thirds of its public debt being jointly owned by its public, banks, corporations and the federal reserve. Debt in local currency is less risky than debt in non-local currency which is affected by exchange rate fluctuations. Interest rate in both countries is also low which helps them to sustain high debt-GDP ratios.

2.5 FISCAL DEFICIT

Fiscal deficit denotes excess of government expenditure over government's income (i.e. revenue). It is commonly expressed as a percentage of GDP. Although fiscal deficit invariably varies from one year to another, unsustainable or high rates of fiscal deficit poses complications of increased demand for goods and services with a resulting high rate of inflation. In light of this, it is important to keep the level of fiscal deficit within healthy limits. This raises the question of what is an ideal limit for the fiscal deficit?

India's fiscal deficit was 5.8 percent in 1980-81. It rose to a high of 7.9 percent in 1985-86 and 8.5 percent in 1986-87. The beginning of 1990s saw higher fiscal deficit of 7.6 percent in 1990-91 but the decade ended with a lower fiscal deficit level of 5.5 percent in 2001. To set an ideal limit to be targeted by the governments (both central and state governments), a Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2003 with a view to reduce deficit, and thereby debt, to sustainable levels. The Act required the central government to contain its deficit to under 3 percent of

GDP. The set target was expected to be achieved over a medium term time frame. The measure was meant to ensure inter-generational equity in fiscal management and long term macro-economic stability. An important change of a far reaching nature in the FRBM Act was that, post-FRBM the fiscal deficit of state governments also began to get accounted. Before the FRBM Act, deficit of state government budgets were allowed to be met by overdraft from the RBI. Such overdrafts used to keep piling up and Finance Commissions used to write them off periodically. However, after the FRBM this practice has been stopped and while the states can take overdraft, if it is not cleared within a stipulated time, they are not extended certain conditional grants from the centre. This way, states have been made more accountable for their fiscal deficit post FRBM.

Following the above major step, in the post-2000 years the Indian economy has witnessed achievement of lower fiscal deficit levels in India. Except for some intermittent high levels (e.g. 2009 and 2010, 6 percent; and 2012, 5.8 percent both owing to a large measure to the package of fiscal stimulus necessitated due to the 2008 world financial crisis), for most of the remaining years the level of fiscal deficit has hovered around 4 to 5 percent with a steady decline in its trend (e.g. 2013, 4.9 percent; 2014, 4.4 percent, 2015, 4.1 percent and 2016, 3.9 percent). It is important to enhance the capacity of raising more revenue by tax collections so as to minimise the need to borrow and thereby large fiscal deficits with consequences of higher inflation rate. Since economic expansion for higher incomes need to be targeted as a goal, for which larger amount of developmental expenditure is invariably needed at an ever increasing rate, a prudent balance needs to be struck between optimal taxation policy, higher revenue generation, larger share of development/ capital expenditure [over that of non-development (or revenue) expenditure], an ideal fiscal deficit and higher share of direct taxes over that of indirect taxes. Since it is impossible to achieve a perfect balance among all these desirables, fiscal policy needs to focus on minimising the consequences of high fiscal deficit by targeting the other factors mentioned above.

Check Your Progress 2 [answer within the space given in about 50-100 words]

1) State the three instruments of fiscal policy.

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2) Illustrate the two major components of taxes viz. direct tax and indirect tax.

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3) In terms of fiscal policy pursued, what reason could be attributed for the relative low growth rate of Indian economy during the decades of 1950-80?

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4) Between capital expenditure and revenue expenditure, what has been the trend in recent years in India? What comment can you make on their relative ratios?

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5) Why is it important to keep the level of fiscal deficit low?

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6) With what objective the FRBM Act 2003 was enacted? What is a change of a far reaching measure in this Act in respect of fiscal deficit of state governments in India?

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2.6 LET US SUM UP

Fiscal policy is important to generate revenue for the government. A larger collection would mean greater ability for government expenditure. Of the two components of tax (direct and indirect), it is important to focus more on the generation of revenue by direct taxes. This is because the incidence of indirect taxes falls more heavily on people with lower incomes. Likewise, in respect of government expenditure, it is important to have a higher share of capital expenditure than revenue expenditure. In the Indian case, revenue expenditure have been far higher than capital expenditure. A major development of post-2000 years is the enactment of FRBM Act in 2003. The Act sets a limit of 3 percent of fiscal deficit to be attained over a medium time frame. A far reaching provision of this Act is the financial deregulation for state governments to raise capital from foreign markets. The tax-GDP ratio has increased from 6.6 percent in the year 1950-51 to about 12 percent in the post-2005 years. This is still far less than the corresponding ratio in developed countries.

2.7 KEY WORDS

Autonomous Consumption : It is a part of private final consumption expenditure which does not depend on income level of consumer. In other words, it represents that level of consumption which will be consumed by consumer even if their income is zero.

Disinvestment : It is a process under which governments sell some part of their shareholding to private investors for the purpose of either raising revenue or minimising fiscal deficit.

Economic Recession : It is a stage of an economy in which economic activities slow down resulting in decline in growth rate and higher level of unemployment.

Fiscal Deficit : (Revenue expenditure + Capital expenditure) – (Revenue receipts + Recovery of loan + other capital receipts) i.e. expenditure minus revenue from capital receipts other than loans taken. In simpler terms, it is: Total Expenditure – Total Receipts (excluding borrowings).

Gross Fiscal Deficit (GFD) : This is the amount excess of total government's current and capital expenditure including loans (net of recovery over revenue) and external grants and non-debt receipts.

Net Fiscal Deficit : Is the gross fiscal deficit minus net lending by the central government.

Gross Primary Fiscal deficit : This is: GFD – interest payment by government.

Capital Expenditure : It is expenditure by government to buy/create productive assets sustainable over long period of time.

Revenue Expenditure : Is the expenditure incurred for revenue transactions or for operational purposes like- salary and wage, rent, etc.

Primary Deficit : It is the amount of fiscal deficit after deducting interest payment on government borrowings.

Revenue Deficit : This is equal to 'Total Revenue Expenditure – Total Revenue Receipts'.

2.8 SOME USEFUL BOOKS AND REFERENCES

1) Kumar Rajiv and Alammu Soumya, (2010). "*Fiscal Policy Issues for India after the Global Financial crisis (2008-10)*". Asian Development Bank Institute, Working Paper No. 249.

2) Rao, N. Govind and R. Kavita Rao. " Trends and Issues in tax Policy and Reform in India." India Policy Forum, NCAER, www.ncaer.org/download/journal/ipf0506-paper2.pdf.

2.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Mobilising resources through taxes and borrowings, maintain price stability, provide incentives for private sector growth and reduce income and wealth inequality.

2) It keeps the interest rate high and thereby limits private investment.

3) Higher taxes reduce aggregate demand, lowers economic activity and reduces private investment. This reduces government's revenue and the resultant decline in social sector expenditure.

4) Personal income taxes varied over 11 slabs from 10 percent to 85 percent. With a surcharge of 15 percent, the marginal rate of direct taxation amounted to a whooping 97.5 percent for those with income exceeding rupees 2 lakhs per annum.

5) In the early 1970s, the marginal rate of direct taxes at the higher levels of income was brought down to 70 percent and later to 66 percent. By 1986, it was further brought down to 50 percent.

6) Slabs and rates of direct taxes were reduced to 3 (with 10, 20 and 30 percent rates) and wealth tax was reduced from 5 to 1 percent. Under indirect taxes, MODVAT which was first introduced in 1986 was extended to most of the commodities by 1997 and three rates of excise duty was merged into one rate called CEVAT in 2000-01.

7) For direct taxes, it reduced from 54 percent in 1995-96 to 32 percent in 2009-10. For indirect taxes, it increased from 20 percent to 48 percent over this period.

8) World economic recessions on the external front and the farm loan waiving and the expansion of MGNREGA on the domestic front. Adequate foreign exchange reserve and big domestic market, among others, helped in minimising the impact on the Indian economy due to the external sector challenge.

Check Your Progress 2

1) The three instruments of fiscal policy are: (i) taxation, (ii) expenditure (transferred payment and direct consumption of government), and (iii) borrowing or debts.

2) Personal and corporate taxes are the main form of direct taxes. Excise duty, service tax and customs duty are examples of indirect tax.

3) Growth is stimulated by government expenditure which depends upon its revenue generating ability. In this, ideally, the proportion of direct taxes should be higher relative to that of the indirect taxes. This ensures greater income in the hands of the people followed by greater taxes. During the years, 1950-80, the indirect tax burden was higher. This impacted adversely on the economic growth rate keeping it low at just an average annual of 3.5 percent over this period.

4) Revenue expenditure over the years 2014-18 has been around 11 to 13 percent of GDP whereas capital expenditure is just about 1.5 to 2 percent. Ideally, the relative ratio should not be tilted towards revenue expenditure but the capital expenditure.

5) The consequences of high fiscal deficit is higher demand for goods and services and higher rates of inflation. In view of this, it is important to keep the fiscal deficit low whereby higher economic capacities generated ensures higher level of incomes and higher levels of government revenue. The spiralling effect should be upwards (higher incomes and higher taxes) and not downwards (i.e. higher inflation and lowered purchasing power and reduced demand).

6) The Act was meant to ensure inter-generational equity in fiscal management and long term macro-economic stability.

UNIT 3 TRADE AND INVESTMENT POLICY*

Structure

3.0 Objectives

3.1 Introduction

3.2 Trade Policy

3.2.1 Import Substitution Industrialisation

3.2.2 Export Led Growth

3.2.3 Convertibility and Deficit of Accounts

3.3 FDI Policy

3.3.1 FII Policy

3.4 Regionalism

3.4.1 Bilateralism and Multilateralism

3.5 Let Us Sum Up

3.6 Key Words

3.7 Some Useful Books and References

3.8 Answers/Hints to Check Your Progress Exercises

3.0 OBJECTIVES

After reading this unit, you will be able to:

- explain the two approaches of 'import substitution industrialisation' and 'export led growth' in international trade;
- discuss the two concepts of 'convertibility' and 'deficit of accounts';
- distinguish between FDI and FII;
- outline the FDI policy pursued by India over different time periods; and
- illustrate the importance of 'bilateralism' and 'multilateralism' in the context of trend in 'regionalism' practiced by countries to promote their respective trade interests.

3.1 INTRODUCTION

Policy of foreign trade and investment are both crucial in the development process. On the imports side, foreign trade is helpful in getting technology, managerial expertise and intermediates essential for growth of the economy. To sustain such imports, exports too need to expand to help finance the imports needed for a high growth path and diversification of the economy. Else, a trade imbalance would induce disruption in the supply of imports causing adverse repercussions for the whole economy. Hence, the foremost

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concern in trade policy is to promote exports in order that there is no difficulty in financing the imports needed for the growth of the economy.

There are many means like institutional innovation, organisational restructuring and policy initiatives which helps attain the desired long run objectives of foreign trade. Among these, policy has a primacy because if policy initiatives are not properly tuned, it transmits an inappropriate set of signals to domestic producers. This equally applies to the Foreign Direct Investment (FDI) as also the Foreign Portfolio Investment (FPI) [or the FII i.e. the Foreign Institutional Investment] policies. Against this background, the present unit begins by making a distinction between the policies of import substitution and export-led growth strategies. Thereafter, it proceeds to explain the foreign trade policy pursued in India prior to 1991 and post-1991 and the FDI and FII policies pursued so far in India.

3.2 TRADE POLICY

For an economy, foreign trade consists of inward and outward movement of goods and services, resulting in inward and outward flow of foreign exchange from one country to another. In present times, international trade policy is a vital part of development strategy. It can be used an effective instrument of economic growth, employment generation and poverty alleviation for an economy.

3.2.1 Import Substitution Industrialisation

Import Substitution industrialisation (ISI) is a trade policy based on the premise that a developing country should attempt to substitute products it imports with domestically produced substitutes. It is an economic development strategy that was in wide use from the end of the World War-II through the mid 1960s. At its zenith in the 1960s, it was adopted by developing countries in Africa, Asia and especially Latin America. The approach was guided by the Prebisch-Singer hypothesis which states that the ‘price of primary commodities, relative to the price of manufactured goods, declines over the long term causing the ToT (terms of trade) of primary product based economies to deteriorate’. To avoid this, many developing countries including India embraced the ISI policy. The ISI has three major tenets or principles viz. (i) an active industrial policy to promote a domestic industrial base (while this is good in itself, the domestic industries tend to grow accustomed to protection from foreign competition with no incentive to become more efficient which makes the tenet to work adversely for the country adopting the ISI strategy); (ii) protective barriers to trade (e.g. tariffs and quotas placed to protect domestic infant industries tend to keep the domestic units uncompetitive and inefficient); and (iii) a monetary policy that rations foreign exchange by multiple exchange rates so as to to channel the imports of intermediate capital goods (i.e. imports are made difficult or expensive discouraging the process of importing).

In India, the state-backed import substitution became the thrust of the trade policy in the late 1950s. Conceived mainly as a long-term solution to India's BoP difficulties, the short-term problems were sought to be taken care of by a tight system of import controls as well as by arranging for a large-scale inflow of assistance. Protection to promote domestic industries through high tariff barriers, multiple exchange rates, import licensing arrangements and subsidies was thus not seen as detrimental to trade and development. The import substitution regime continued till 1981. Such prolonged use of ISI policy in India is since recognised to have resulted in market concentration, high unit cost of production, overvaluation of currency, extreme government intervention in production, etc. cumulatively contributing to an anti-export bias. Thus, the ISI strategy yielded neither industrialisation nor growth with the long term growth from the late 1950s to 1981 having remained an average 3.5 percent per annum. It is only in the post-1980s, with the adoption of ELG strategy that the economy started growing at a faster long term average annual growth rate of 5.5 percent successively till the later years of 1990s when the growth rate peaked to cross the 7 percent mark.

3.2.2 Export Led Growth

Export–led growth (ELG) is an economic development strategy emphasising on the exploitation of a country's actual or potential comparative advantage in production for foreign markets. In other words, ELG is a trade and economic policy, opposite to the ISI policy, aiming to speed up the industrialisation process of a country by promoting export of goods for which the nation has a comparative advantage. It is contrasted with the ISI policy since it is 'outward looking' whereas ISI is 'inward looking'. Modern forms of export-led growth strategy first came to prominence in the 1960s when several East Asian countries turned away from the ISI approach and began to promote export of manufactured goods. The success of these Asian export economies, who came to be identified as the Little Dragons or Four Tigers, questioned the idea of export pessimism i.e. the belief that low and middle income developing economies could not compete with manufactured goods in developed country markets. With this, by the mid-to-late 1980s, the strategy of export-led growth had completely replaced the ISI orthodoxy.

In addition to the demonstration effect of East Asian export economies, several other factors stood behind the success of ELG strategy as a policy idea. Prominent among them are: (i) the loss of confidence in interventionist, state-led management of the economy; (ii) the failure of traditional ISI policies to address the worsening economic conditions of Latin America (stemming from its debt crisis of the 1980s); and (iii) the communication and transportation revolution of the last decades of the twentieth century. In particular, the technological changes in transport and communications enabled firms to locate the production units abroad and increased the opportunities for developing countries to participate in production processes spanning across nations. All these changes supported the idea of pursuing the comparative advantage and ELG as engines of growth.

India initiated its export-led growth strategy in the early 1990s when its economy was begun to be integrated with the world economy. As a result, India's merchandise exports share in world exports increased from its share of 0.5 percent in 1990 to 1.7 percent in 2013. Although this is a meagre increase compared to the corresponding jump achieved by many other competing economies, over the years, the trade policy of India has undergone fundamental shifts to correct the earlier anti-export bias through the removal of various quantitative restrictions (QRs), reduction and rationalisation of tariffs, liberalisation in the trade and payment regime, adoption of various export incentive measures, movement toward markets based exchange rates, etc. These measures indicate that the country has seriously opted for ELG strategy so as to improve the competitiveness of Indian products in the global market.

3.2.3 Convertibility and Deficit of Accounts

Currency convertibility refers to the right/freedom to covert the domestic currency into other internationally accepted currency and vice versa. Convertibility has two dimensions: (i) current account convertibility and (ii) capital account convertibility. Current account convertibility refers to the freedom in respect of payments and transfers for current international transactions. Capital account convertibility, on the other hand, implies the freedom to convert local financial assets to foreign financial assets (and vice versa), at market determined exchange rate, without needing approval from the government. In other words, capital account convertibility (CAC) implies complete mobility of free and unregulated capital funds across countries with no restrictions. With growing strength of the BoP, India could make the Rupee fully convertible on current account in 1994.

With increased integration of the Indian economy with other countries, there is a need for introducing CAC for integration of financial markets across countries. There are certain advantages of CAC. Firstly, with CAC, the cost of capital would come down as there would be more capital inflow into the country. Secondly, tax levels would come down to international levels reducing tax evasion and capital flight. Thirdly, resident individuals would have the right to acquire financial assets abroad. Fourthly, with Indian mutual funds becoming free to invest abroad, investment in overseas markets would enable setting up of joint ventures. In spite of these advantages, and many officially sponsored reports recommending the introduction of CAC in India, India has not embarked on full CAC. This is a prudent cautionary stand as there are also some risks with full and unconditional CAC. The risks are broadly on two fronts: (i) it could expose the economy for currency devaluation, takeovers, short term macroeconomic disturbances like increased unemployment, etc. and (ii) at the extreme, there could be risks impinging on the sovereignty concerns particularly where the size of the economy is small. In view of the actual size of the Indian economy, the latter risk mentioned above is certainly in the very extreme, but the first risk of short term nature also needs due calibration of CAC relaxation over time. This is exactly the stand adopted by India on total CAC.

Deficit of Accounts: You are aware that the Balance of Payments (BoP) is a systematic record of all international financial and trade transactions that occur between a Home Country and the rest of the world within a given time period. Defined as Exports (X) minus Imports i.e. X – M, a deficit in BoP could result in three type of accounts viz. (i) Trade Account deficit (or simply trade deficit), (ii) Current Account deficit and (iii) Capital Account deficit. The trade deficit [or balance of trade (BoT) deficit] refers to the excess of merchandise imports (M) over merchandise exports (X) i.e. M – X. Thus, BoT is in surplus or deficit depending on whether X – M is positive or negative. Current account deficit indicates increase in the indebtedness of the nation to the rest of the world. In other words, it is the excess of expenditure over receipts on current account in a country's BoP. While this reflects the immediate short term health status of the economy, capital account deficit (CAD) reveals that the long term health of the nation is deteriorating. Taking all the three into account, the BoP deficit is defined as the sum total of the current account deficit and the capital account deficit. Thus:

BoP Deficit = Current Account Deficit + Capital Account Deficit.

Check Your Progress 1 [answer within the space given in about 30-100 words]

1) Why is a 'trade policy' important for an economy?

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2) What is the underlying philosophy behind the ISI strategy? On what foundation is it based?

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3) What are the three basic tenets of ISI strategy and how do they begin to work against the economy practising the ISI approach?

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4) In what way is the India's practising of the ISI strategy acknowledged to have negated the expected benefits from the ISI approach?

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5) What factors led to the adoption of the ELG strategy by several economies in the late 1960s? What factors indicate the seriousness of India's adopting the same in the post-1990s?

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6) Distinguish between current account convertibility and capital account convertibility.

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7) State the advantages of 'capital account convertibility'.

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8) In spite of many perceived advantages of capital account convertibility, what has been the stand of Indian government in this regard? Why? Do you support such a stand?

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3.3 FDI POLICY

FDI flows come as capital bundled with technology, skills, and sometimes even market access. They are, therefore, perceived as important resources for expediting the industrial development of recipient countries. Most developing countries, therefore, have a welcoming attitude towards MNCs and FDI since it fosters growth by increasing capital accumulation, technological change, efficiency, BoP improvement, increase of exports, increase in the overall total amount of investment in the domestic economy, improved access to world markets, help in release of resource constraints on investment, etc. India's FDI policy has so far gone through three main phases as outlined below.

A) **First Phase (1950-1980)**

During this phase, India was receptive to foreign capital, particularly foreign direct investment (FDI). This is indicated in the assurance made by the government in 1949 by stating that: (i) there shall be no discrimination between Indian and foreign undertakings; (ii) facilities will be given to foreign investors for remittances of profit; and (iii) due compensation will be paid in case a foreign undertaking is nationalised. The attitude towards foreign capital remained unchanged in the 1956 Industrial Policy Resolution (IPR). Foreign Investment policy in this phase was largely determined by the struggle between the government and monopoly foreign interests, particularly TNC oil companies.

B) **Second Phase (1980-91)**

The period saw the initiation of liberalisation process and was guided by the principle of relaxation of controls which acted as constraints. The approach to industrial policy saw the delicensing of industries and the scrapping of the 1969 MRTP Act. However, liberalisation in this period was restricted to limited foreign collaboration. The industrial policy statement of 1977 particularly discouraged foreign collaboration by stating that the inflow of technology would be allowed only in sophisticated and high priority areas where Indian technology had not adequately developed. In areas where foreign technology was not further needed, renewal of foreign collaborations was discouraged.

C) **Third Phase (Post 1991)**

With the announcement of new Industrial Policy of 1991, a new phase in FDI began. After following a restricted FDI policy for more than four decades since Independence, India liberalised its FDI policy considerably. Besides opening new sectors (e.g. banking, mining, insurance telecommunications) to FDI and dismantling of controls and regulations, the government allowed huge concessions and relaxations. In particular, the main measures announced since 1991 to give a boost to FDI are as follows.

a) Many industries were deregulated and opened to FDI. The Foreign Investment Promotion Board (FIPB) was allowed to sanction 100 percent equity participation in cases where Indian companies were unable to raise funds.

b) Procedures for obtaining permission were simplified by listing industries eligible for automatic approval up to specified levels of foreign equity. For instance, 51 percent foreign equity was permitted with automatic approval in industries producing intermediate and capital goods;

c) Besides FDI, portfolio equity investment (PEI) from abroad was also given an impetus. Under this, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market thereby opening a window for portfolio investment in existing companies. Thus FIIs were allowed to operate in the Indian capital market and Indian companies were allowed to raise capital in the international market. These policy changes have led to a significant increase in FDI flows from negligible levels in 1990 to over $35 billion in 2014-15.

While the above measures are of the period 1991-95, post-1995 a series of more liberalising measures were taken. These are:

a) Introduction of dual route of approval of FDI i.e. RBI's automatic route and the FIPB route;

b) Automatic permission for technology agreements in high priority industries;

c) Removal of restriction of FDI in low technology areas and liberalisation of technology imports;

d) Permission to NRIs and overseas corporate bodies to invest up to 100 percent in high priority sectors;

e) Hike in foreign equity participation limits to 51 percent for existing companies;

f) Foreign equity participation for up to 100 percent for projects relating to electricity generation, transmission and distribution, and roads and highways, etc.;

g) Increasing the ceiling for FDI in oil refining from 49 percent to 100 percent;

h) 100 percent FDI in telecommunication sector, tea sector, airports, etc.

In more recent years (2014), an investor-friendly FDI policy to permit FDI of up to 100 percent under the automatic route in most sectors/activities (e.g. construction, operation, and maintenance of identified railway transport infrastructure) except in defence where FDI cap is kept at 49 percent is implemented. Norms related to minimum land area, capitalisation, and repatriation of funds for FDI in construction development projects have been further liberalised. However, in some sectors FDI is completely banned. These are: retail trading (except in single-brand wholesale trading), atomic energy, lottery, real estate business, chit fund business, cigarette manufacturing, etc. In 2016, the government allowed 100 percent FDI for marketplace e-commerce. During this period, FDI in the pension sector has been revised to permit foreign investment up to 49 percent, with 26 percent under automatic route.

The result from this FDI policy is that FDI as a percentage of gross domestic investment (GDI) and GDP has grown rapidly between 1991-92 and 2015-16. Despite this expansion, FDI inflows to India is low compared to other countries of Asia. Ironically, despite the investment friendly liberal FDI regime, India is ranked 'fourth' on the basis of 'FDI Restrictiveness Index'. Though the actual inflow of FDI has not been as high compared to what it is in some other countries, it has improved and strengthened the capital account of the BoP of the country.

3.3.1 FII Policy

The entry of FIIs after 1992-93 is a follow up of the recommendation of the Narsimham Committee Report on Financial System. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Post-1992, the Indian stock markets were opened up for direct participation by FIIs. FIIs were allowed to invest in all securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed in the stock exchanges in India.

In 1998, Indian companies were allowed to issue bonus shares (or right shares) to the GDR/ADR (i.e. Global or American Depository Receipts) holders after obtaining necessary permission. Subsequently, the FIIs were allowed to invest in the securities of unlisted companies, treasury bills and government securities. The norms for FIIs' investment in convertible bonds were also liberalised. In short, the evolution of FII policy in India has taken the form of: (i) relaxation of investment limits for FIIs; (ii) relaxation of eligibility conditions; and (iii) liberalisation of investment instruments accessible to FIIs.

3.4 REGIONALISM

Regionalism is a term used (in the GATT and the WTO) to refer to Preferential Trade Agreements (PTAs). The dictionary of Trade Policy Terms describes regionalism as the process by which regional trading agreements (RTAs) serve as 'actions of governments to liberalise or facilitate trade on a regional basis'. RTAs can take several forms viz. (a) free trade areas, (b) custom unions, (c) common market and (d) economic unions. *Free trade areas* agree to reduce or abolish trade restrictions between member countries while allowing members to impose their trade restrictions against non-members. *Custom unions* encourage free trade among members but erect a common external tariff on imports from non-member countries. *Common markets* are similar to custom unions but include the free movement of factors of production as well as trade. It is a deeper form of integration as it requires a greater degree of harmonisation of domestic policies between the member states. Finally, *economic unions* take the development of a common market even further by encouraging harmonisation of national economic policies, such as competition policy, financial regulations, and product standards.

Concern regarding the fragmentation of the world trade system has grown with the rapid proliferation of regionalism or preferential trade agreements in recent years. Several hundred Preferential Trade Agreements (PTAs) are currently in existence. Indeed, many countries belong to multiple PTAs, resulting in a confusing criss-crossing of trade preferences. Among the more prominent existing RTAs are the North American Free Trade Agreement (NAFTA), the European Economic Community (EEC), the European Free Trade Association (EFTAs), MERCUSUR (Custom Union between the Argentine Republic, Brazil, Paraguay, and Uruguay), the Association of South East Asian Nations (ASEAN), Asian Free Trade Area (AFTA), the Trans-Pacific Partnership (TPP) agreement, etc.

In the past, India had adopted a cautious approach to the RTAs. Since late 2000s, recognising that RTAs/PTAs/FTAs would continue to feature prominently in world trade, given the slow nature of multilateral negotiations under the rules and regulations regime of the WTO, India has begun moving towards FTAs/RTAs and Comprehensive Economic Cooperation Agreements (CECAs) [e.g. Agreement on South Asia Free Trade Area (SAFTA), India-ASEAN Comprehensive Economic Cooperation Agreement (CECA), India Pacific Trade Agreement (IPTA) etc. The net impact of the RTAs on export performance and trade.

3.4.1 Bilateralism and Multilateralism

Bilateralism or Bilateral Trade Agreements are two way agreements on trade between two countries to extend specific privileges not extended to others. It became widespread in the 1930s with countries trying to protect themselves from the fall in international trade during the depression. While India has always stood for rule based multilateral trading system (MTS), in recent years, it has been active with bilateral agreements. Some of the important bilateral agreements of India with other countries are: EHS (Early Harvest Scheme) with Thailand, India- New Zealand FTA-CECS, India-Canada FTA and India-Australia CECA.

Multilateralism or Multilateral trade agreements are the agreements for deepening global trade and development. They are founded on the core principle of non-discrimination. They are guided by the rules and regulation of the World Trade Organisation (WTO). Ministerial Decisions under WTO at different Conferences have focused on agriculture, cotton and issues related to least developed countries (LDCs). These cover public stockholding for food security purposes, Special Safeguard Mechanism (SSM) for developing countries, commitment to abolish export subsidies for farm exports in developed countries and measures related to cotton. Decisions are also made in WTO on preferential treatment to LDCs in the area of services and the criteria for determining how exports from LDCs can be beneficial to them.

Check Your Progress 2 [answer within the space given in about 50-100 words]

1) What was the stand of the Indian government on FDI at the time of independence and immediately after it in the 1950s?

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2) What was the attitude of the government during the 1970s towards FDI and foreign collaboration?

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3) What major strides were initiated to encourage the flow of FDI in the post-1991 years in India?

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4) What are some of the further liberalised measures initiated in the more recent years (post-2010) to encourage the flow of FDI to India?

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5) How is FII different from FDI?

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6) In what respects would you summarise the opening up of the Indian markets to the FIIs?

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7) Define the term 'regionalism'. What trend would you notice in respect of FTAs in India? Why?

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8) Distinguish between bilateralism and multilateralism with examples. Why has multilateralism come to occupy a back seat of late?

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3.5 LET US SUM UP

While the ISI strategy is inward looking, aimed at boosting the domestic industrial base by protection from foreign competition and imports, ELG is an outward looking export oriented growth policy. India practiced the ISI strategy with limited and cautious exposure to FDI for nearly four decades after which it too adopted the ELG strategy. The growth of the economy in the post-1980s, and then in the later years of 1990s, are testimony to the fact that the ELG strategy is superior to that of the ISI strategy. The policies adopted for FDI has also seen a distinct shift from the cautious stand demonstrated for close to four decades and the welcoming stand adopted in the years after the 1990s. While this has been the trajectory of India in respect of its investment policy, on trade, India has always believed in non-discriminatory multilateralism. However, owing to the difficulties of negotiations on interests of India and the other LDCs in the WTO, there has been a concerted shift towards FTAs, RTAs and PTAs in the recent years.

3.6 KEY WORDS

ISI	:	ISI is a trade and economic policy based on the premise that a developing country should attempt to substitute products it imports with domestically produced products.
Unorganised FDI and FII	:	FDI is a long term international capital movement directly made in development projects in other countries. It refers to movement of investible funds or finance. If the lender has operating control over the asset's use, then investment is direct, otherwise it is portfolio or the FII.
Regionalism and Multilateralism	:	Regionalism is the process by which the actions of governments to facilitate trade on a regional basis is promoted. Multilateralism are agreements between a group of countries for deepening global trade. It is founded on the core principle of non-discrimination.

3.7 SOME USEFUL BOOKS AND REFERENCES

1) Hussain Abid (1995). 'Foreign Trade Policy in Indian Planning', in Banerjee, Kalyan and Tarjani Vakil (eds.), *India: Joining the World Economy,* Tata McGraw-hill Publishing Company Limited, New Delhi.

2) Karmakar Asim K (2010). *Balance of Payments Theory and Policy: The Indian Experience,* Deep and Deep Publications, New Delhi.

3) Karmakar Asim K and Biswajit Chatterjee (2000). *'Trade and Payments Policy Regimes in India Since Independence',* in Amitabh Shukla (ed.),

International Money Market and Indian Economic Reforms, Kanishka Publishers, Distributors, New Delhi.

4) Sharan Vyuptakesh and Indra Natn Mukherjee (2001). *India's External Sector*, Oxford University Press, New Delhi.

3.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) For achieving good economic growth, trade between countries is essential as any economy cannot have the comparative advantage required to produce all that goods that it requires. The imports made need to be financed for which in order to earn the necessary foreign exchange there should be corresponding exports. Thus, policy to promote exports and imports, or to engage in trade beneficial for the economy, is very crucial. In its absence, a trade imbalance would disrupt the economy in its growth path.

2) It is based on the premise that importing economies should substitute the products being imported with what can be domestically produced as their substitutes. Its foundation is based on the Prebisch-Singer hypothesis which states that in the long run the economies exporting the primary commodities would stand to lose in terms of the ToT advantage in comparison with the economies exporting manufacturing goods.

3) The ISI strategy works on three tenets viz. promotion of domestic industries, protection from foreign products through high tariff rates and quotas and a monetary policy practicing multiple exchange rates and control over foreign exchange. Though the measures are basically aimed at promoting the domestic industrial base, in effect they induce them to remain uncompetitive and inefficient.

4) The acknowledgement is made in terms of concentrated market structure, high unit cost of production, overvalued currency and high degree of government intervention in production systems, etc. cumulatively resulting in an anti-export bias.

5) The loss of confidence in the state-led interventionist approach, failure of ISI to address the Latin American debt crisis and the developments in the ICT sector enabling the setting up of manufacturing sector anywhere where there is a comparative advantage in production. On India's part, phased removal of QRs, progressive reduction of tariffs and subsidies, liberalisation measures in the trade and payments regime, adoption of various export incentive measures, movement towards market based exchange rates, etc. indicate the seriousness in its adopting the ELG strategy.

6) Current account convertibility provides freedom in respect of payments and transfers for current international transactions. Capital account convertibility refers to a far wider freedom to convert local financial assets to foreign financial assets (and vice versa) at market determined exchange rate. Capital account convertibility (CAC) therefore implies total free and unregulated mobility of capital funds across countries with no restrictions.

7) It reduces the cost of capital due to increased capital inflow into the country. Tax levels would come down to international levels which in turn reduces tax evasion and capital flight. Resident individuals would have the right to acquire financial assets abroad. Mutual funds would become free permitting their investment in overseas markets enabling setting up of joint ventures.

8) In spite of the many advantages of CAC, there are also risks mainly on two fronts: (i) it could expose the economy for currency devaluation, takeovers, short term macroeconomic disturbances like increased unemployment, etc. and (ii) in the extreme, there could be risks impinging on the sovereignty concerns. However, in view of the size of the Indian economy, the latter risk is not high. But due to the criticality of the short term risk, India has adopted gradual moderation of its CAC policy, on a year to year basis, through its EXIM policies announced. Due to this reason, the cautious stand of the Indian government is creditable.

Check Your Progress 2

1) The government assured equal treatment to MNCs including facilitation for repatriation of profits and compensation in case of nationalisation. The second IPR of 1956 also adopted a similar stand.

2) The attitude of the government was one of restricted or limited collaboration in sophisticated and high priority areas where competence of Indian technologies was inadequately developed.

3) Establishment of Foreign Investment Promotion Board to allow 100 percent equity participation, simplification of procedures to allow 51 percent foreign equity by merely listing such industries where this was allowed, allowing the FIIs to operate in the Indian capital market, allowing the Indian companies to raise capital in the international market, introduction of a dual RBI automatic route for FDI, removal of restrictions on FDI in low technology areas, etc.

4) Permitting FDI of up to 100 percent in most sectors/activities, Relaxation of norms on capitalisation and repatriation of funds raised for construction development projects, allowing of 100 percent FDI for marketplace in e-commerce, permitting of 49 percent FDI etc.

5) FDI refers to investment in development projects (like infrastructure projects) directly. The capital invested remains in the domestic economy with only the profits made repatriated. FII, on the other hand, relates to investment of capital in the equity markets including securities (i.e. stock exchanges) where capital can leave the economy over night. Investment in FII only reflects the investors sentiment or confidence in the stock market whereas FDI shows a long term commitment linked to the growth prospects in the economy in which investment is made.

6) The evolution of FII policy in India could be summarised by way of: (i) relaxation of investment limits for FIIs; (ii) relaxation of eligibility conditions; and (iii) liberalisation of investment instruments accessible to FIIs.

7) Regionalism is defined as cooperation between countries to liberalise or facilitate trade between countries of a region. Since late 2000s, there has been an increase in the number of PTAs/FTAs/RTAs in India in view of the fact that the negotiations in the WTO for multilateral negotiations have been slow and dragging.

8) Bilateralism refers to agreement on trade concessions between two countries. Examples are: EHS between India and Thailand. Multilateralism, on the other hand, are guided by the rules and regulations of the WTO founded on the core principle of non-discrimination. Reasons for decline of multilateral agreements under WTO include contentious issues like protection of farm sectors' interests in LDCs vis-à-vis huge export subsidies given by the developed countries for farm exports.

UNIT 4 LABOUR LAWS AND REGULATIONS*

Structure

4.0 Objectives
4.1 Introduction
4.2 Labour Policy Prior to Independence in India
4.3 Labour Laws for Organised Sector
4.3.1 Working Conditions
4.3.2 Employee Relations
4.3.3 Wages and Monetary Benefits
4.4 Social Security Laws
4.4.1 Organised Sector
4.4.2 Unorganised Sector
4.5 Recent Labour Reform Measures
4.6 Let Us Sum Up
4.7 Key Words
4.8 Some Useful Books and References
4.9 Answers/Hints to Check Your Progress Exercises

4.0 OBJECTIVES

After reading this unit, you will be able to:

- state the objectives of labour policy;
- outline the historical context in which labour laws got instituted in India;
- discuss the various laws for labour welfare under which the organised sector employees in India are covered;
- explain the arrangements for social security for the organised and unorganised sector workers in India;
- illustrate the recent measures of 'labour reform' initiated in recent years in India; and
- identify the changes required in the Industrial Disputes Act of 1947 in order to stimulate demand for labour and employment generation in India.

4.1 INTRODUCTION

The labour policy derives its philosophy and content from the Directive Principles of State Policy as laid down in the Constitution of India. The Article 43 of the Constitution states that: The State shall endeavour to secure,

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by suitable legislation and economic organisation, to all workers – agricultural, industrial or otherwise – work/employment at living wages and appropriate conditions, ensuring a decent standard of life and full employment with leisure time for pursuing social and cultural opportunities.

While in the early decades of independence, the labour policy was preoccupied mainly with the organised sections of the labour force, attention during the post-2005 years has been paid to take care of the interest of the workers in the unorganised sector. An organised sector unit is defined as 'establishments governed by at least one legislation to protect the interest of their workers'. The Ministry of labour, Government of India, in its administration of various provisions of 'compulsory notification of vacancies for the organised sector of the economy' [under their Employment Market Information (EMI) surveys], covers 'all establishments in the public sector irrespective of their size and non-agricultural establishments in the private sector employing more than 25 workers on a compulsory basis and 10-24 workers on a voluntary basis'. Another important survey, the Annual Survey of Industries which collects data on Industrial Statistics in India, covers all factories registered under the Factories Act, 1948. The scope of the ASI surveys includes 'all factories employing 10 or more workers if using power, and 20 or more workers if not using power'.

The labour policy of India has been evolving over time in response to the specific needs of the situation and to suit the requirements of planned economic development and social justice. The legislative measures are evidences of diversification of labour policy to progressively fulfil the Directive Principles of the Constitution. The objective of any labour policy is to ensure a conducive environment to labour-management cooperation.

4.2 LABOUR POLICY PRIOR TO INDEPENDENCE IN INDIA

When the Royal Commission on labour set up in 1929 submitted its reports in 1931, the working class in India was not sufficiently organised. In view of the prevailing conditions of strikes and lockouts resulting in strained relations between the employers and the employees, the Commission recommended: (i) trade unions' right of negotiation, (ii) setting up of Labour Welfare Officer, Wage Boards and Works Committee, (iii) maternity benefit legislation, (vi) housing facilities, (vii) permanent statutory machinery to deal with disputes, etc. Hence, much of the labour policy of India in the initial stages originated with the recommendation of this Royal Commission. Later, during the World War-II a need was felt to meet the war needs by improving the labour conditions to achieve higher production. With the end of the war, the priority was shifted to securing a higher standard of living for the workers and ensure a continuous supply of skilled hands to meet the needs of growing Indian industries. A landmark in the field of labour policy was the appointment of the Labour Investigation Committee in 1944 to look into the issues of wages, employment, housing, conditions of work in factories, etc. The Commission, in its report submitted in 1946, recommended: (i) a code of safety to reduce accidents, (ii) state funded insurance against employment injury, occupational diseases and maternity benefits, (iii) linking dearness allowance (DA) with cost of living index and (iv) recognition of trade unions. It was thus realised that without satisfying the labour class, the industrial development is not possible and hence serious thought must be given to the formulation of a national labour policy. The then Ministry of Labour drew up a four-year phased programme, 1947-51, to develop basic labour standards in respect of working conditions, health, welfare and safety in industrial undertakings. The programme attempted to: (a) revise the existing labour legislation to meet the changing needs of the time; (b) eliminate completely and/or control contract labour; (c) extend employment opportunities/ exchanges to cover all classes of workers; (d) evolve fair terms of service and deal for workers; (e) fix wages in sweated industries; (f) rationalise rates of dearness allowance to promote fair wages; and (g) lay down the nucleus for an industrial health insurance programme.

The industrial policy statement of 1945 emphasised that one of the objectives of new industrial policy would be, 'to secure for industrial workers a fair wage, decent conditions of work and reasonable security of tenure'. In Independent India, the Constitution which was enacted in 1950 ensured a decent living of working conditions, a living wage and social security for workers.

4.3 LABOUR LAWS FOR ORGANISED SECTOR

The various laws pertaining to labour welfare and regulation can be classified under four heads. Laws relating to: (A) working conditions; (B) employee relations; (C) wages and monetary benefits ; and (D) social security. In this section we will study some of the important laws pertaining to the organised sector.

4.3.1 Working Conditions

Under this, we shall briefly study the objectives and provisions of the following six Acts, being implemented for different sections/sectors of labour, in order of the chronology (1948, 1951, 1952, 1970, 1979 and 1985) in which they were enacted.

1) **The Factories Act, 1948:** Under this Act, the term 'factory' is defined as a premises where a manufacturing process is carried out 'by 10 or more persons if using power or by 20 or more persons if not using power'. The Act mandates registration of factories subject to the above definition and provisions working conditions relating to: (i) health precaution of workers, (ii) welfare and safety of workers, (iii) conditions under which women work, and (iv) working hours for adults and children. The maximum work hours have been fixed at 48 hours a week,

or daily hours not exceeding 9 hours. The use of child workers below 14 years is prohibited. Leave with wages for workers, protection against hazardous operations, payment of over-time, inspection of the working conditions in factories by inspectors, the role of authorities under the Act, etc. are specified. The Act obligates every employer to register his factory and obtain a license from the State government before the factory is set-up.

Under the safety provisions, the Act provides detailed specifications about the space to be provided to every person workings in the factory, installation of machines and their fencing, etc. The Act was substantially amended in 1987. The amendment was consequent to the Bhopal gas disaster in which nearly 8,000 people died and many thousands got disabled. This disaster led to introspection by the government about the adequacy of the provisions of the Factories Act. The amendment was carried out in 1987, and a new chapter IV-A was inducted into the Act. The amendment tightened the provisions relating to hazardous processes. The Amended Act substantially enhanced the penalties to be inflicted on persons responsible for the violation of the Act. Imprisonment period has also been enhanced up to two years.

The Factories (Amendment) Bill 2005 was introduced to provide flexibility in women's employment with adequate safeguards such as provisions of shelters, rest rooms, protection of dignity and safety, protection from sexual harassment, etc. The Act is criticised on the ground that it does not cover workers of the unorganised sector as also of very small establishments. Inspection of factories also remains unsatisfactory.

2) **The Plantation Labour Act, 1951:** The conditions of workers employed in plantations are regulated by the Plantation Labour Act (PLA). The Act applies to plantations of coffee, rubber and cinchona. All plantations are required to be registered with a registration officer appointed under the Act. The provisions of PLA mainly deal with health and welfare measures. These include: drinking water, medical facilities, crèches, recreational facilities, educational facilities and housing for workers and their families.

3) **The Mines Act, 1952:** The Mines Act provides for health, safety and welfare of workers employed in mines. The term 'mine' refers to any excavation operation carried out for the purpose of obtaining minerals. The Act provides for various health and welfare provisions for those working in the mines. These include: supply of drinking water and medical appliances. A person who has not attained the age of eighteen years is prohibited from working in a mine.

4) **The Contract Labour (Regulation and Abolition) Act, 1970:** The Contract Labour (Regulation and Abolition) (CLA) Act seeks to regulate

the employment conditions of contract workers and provides for its abolition in certain circumstances. As per the CLA, all employers employing contract labour are required to register themselves with the registrar appointed by the government. The contractor working for the principal employers are required to obtain a license from the authorities. It is thus mandated for the employer to employ contract labour in a legal way that is permissible under the law. Contract labour use has grown throughout the world over the last few decades, especially after the onset of the globalisation process. In India, their numbers have increased from 12 percent of all registered manufacturing workers in 1999 to over 25 percent in 2010. The Act provides for prescribed health and welfare measures for contract labour as stipulated in chapter V of the CLA.

5) **The Inter-state Migrant Workmen (Regulation of Employment and Conditions of Service) Act, 1979:** Indian industries employ a good number of inter-state migrant workers. The Inter-state Migrant Workmen (Regulation of Employment and Conditions of Service) Act (ISMWA) was enacted with a view to protecting the migrant workers from exploitation. The Act provides for certain minimum conditions of employment by issuing a passbook to every inter-state migrant worker which contains details about: (i) employment, (ii) payment of displacement allowance, (iii) payment of wages during the period of the journey, (iv) residential accommodation and medical facilities, (v) protective clothing and (vi) equal pay for equal work irrespective of gender.

6) **Child Labour (Abolition and Regulation) Act, 1985:** It is estimated that the largest number of child workers in the world are in India. The Child Labour (Abolition and Regulation) Act (CLARA) prohibits the employment of children below the age of fourteen years in factories and hazardous employment which includes glass and glassware, fireworks and match making, and carpet weaving. In cases where children are allowed to work, the Act regulates their working hours.

4.3.2 Employee Relations

The legislation for employee relations are covered under three principal laws viz. (i) the Trade Unions Act, 1926 (TUA), (ii) the Industrial Employment (Standing Orders) Act, 1946 and (iii) the Industrial Disputes Act. 1947 (IDA). The salient features of these three laws are discussed below.

1) **The Trade Unions Act, 1926:** The Trade Union Act (TUA) provides for registration of trade unions and thus creates a countervailing power in favour of the working class. The Act provides that all employees employed in industry, including managers, can become members of trade unions. The TUA confers immunity upon a registered trade union and its members against certain civil and criminal acts. The rationale of providing such immunity is to allow a registered trade union and its

members their right to withdraw labour if they perceive exploitation, and use that situation of work stoppage as a leverage in the bargaining process.

2) **The Industrial Employment (Standing Order) Act, 1946:** The Industrial Employment (Standing Orders) Act (IESOA), defines conditions of work for different categories of workers making them conscious about their employment rights. The Act applies to industrial establishments employing 100 or more workers.

3) **The Industrial Disputes Act, 1947:** The IDA provides a statutory machinery for dispute resolution. The machinery consists of a three stage process viz. conciliation, adjudication and arbitration aimed at resolving the industrial disputes whenever negotiations fail. The machinery applies to both individual as well as collective interests and rights. The three stages are sequential i.e. where a dispute is not resolved through the mechanism of conciliation, it can go for adjudication. Three adjudicatory bodies are prescribed viz. labour courts, industrial tribunals and national tribunals. The arbitration of industrial disputes is provisioned by a mutually agreed arbitrator who is selected by both the disputant parties.

As per the IDA, the state can intervene in any dispute between employers and employees who are expected to inform the labour commissioner before declaring a lockout or going on a strike. In all such cases, if the factory employs hundred or more workers, to retrench even a single worker an employer must seek the permission of the state labour commissioner. An amendment to the Act in 1976, raised the ceiling on employment in firms to 300 but in 1982, the ceiling for seeking permission to retrench workers was rolled back once again to 100 workers. This law therefore makes it more or less impossible for firms coming under the purview of the Act to retrench workers.

4.3.3 Wages and Monetary Benefits

Under this, we discuss the main features of four pieces of legislation viz. (i) the Payment of Wages Act (POWA), 1936; (ii) the Minimum Wages Act (MWA), 1948; (iii) the Payment of Bonus Act (POBA), 1965; and (iv) the Equal Remuneration Act (ERA) 1976.

1) **The Payment of Wages Act, 1936:** This is one of the earliest labour laws enacted in colonial India with the objective of ensuring: (i) the payment of wages on time to the worker, (ii) that payment is made in current coin, and (iii) that no impermissible deductions are made from them. The Act applies to factories, railways and other establishments.

2) **The Minimum Wages Act, 1948 (MWA):** The Act provides for fixation, review, revision and enforcement of minimum wages in respect of 'scheduled employment'. The Act is aimed at preventing workers from being exploited. The Act does not discriminate between male and

female workers for wages. The minimum wages can be fixed in the form of a time rate or a piece rate with a guaranteed time rate and an overtime rate. It is mandatory on the part of the employers to pay minimum wages. The shortcomings of this Act are that while this Act is observed by large and medium units, small units evade the provision. Another shortcoming relates to ensuring payment of fair wages to workers. As a result, not only the Act could not be enforced in rural areas, the entire agricultural sector employing 50 percent of workforce is left out of the ambit of this Act denying them the payment of even the minimum wage stipulated under this Act.

3) **The Payment of Bonus Act (POBA), 1965:** The Payment of Bonus Act (POBA), envisages a scheme of sharing the gains of industry between the employer and the employees. The Act applies to all factories defined under the Factories Act, 1948, and all establishments wherein twenty or more persons are employed on any day during the accounting year.

4) **The Equal Remuneration Act, 1976:** The Equal Remuneration Act (ERA), applies to all establishments whether belonging to the public or the private sector. It envisages a duty on the part of all employers to pay equal remuneration to men and women for doing the same work or work of similar nature.

Check Your Progress 1 [answer within the space given in about 50-100 words]

1) How is an 'organised sector' unit defined in India?

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2) What are the two amendments made to the Factories Act, 1948?

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3) On what grounds is the Factories Act criticised?

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4) In what way the Contract Labour Act, 1970 has become important in the current times?

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5) What is the rationale behind the Trade Union Act, 1926?

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6) Identify the strength and weakness of the ID Act, 1947?

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7) What is the major shortcoming of the Minimum Wages Act, 1948?

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4.4 SOCIAL SECURITY LAWS

Social security is the protection which society provides for its members against the economic and social distress. The State bears the primary responsibility for developing appropriate systems for providing protection and assistance to its workforce and their families.

4.4.1 Organised Sector

In India, social security is treated as part of labour law. The principal social security laws enacted are the following: (i) The Workmen's Compensation Act (WCA) 1923; (ii) The Employees' State Insurance Act (ESIA) 1948; (iii) The Employee' Provident Funds (and Miscellaneous Provisions) Act (EPFA) 1952 [including the Employees Pension Scheme (EPS) 1995]; (iv) The Maternity Benefit Act (MBA) 1961; and (v) The Payment of Gratuity Act (PGA) 1972.

1) **The Workmen's Compensation Act (WPA) 1923:** The Act provides for payment of compensation to workmen and their dependants in case of injury and accident (including certain occupational diseases) arising out of the course of employment resulting in disability or death. The Act covers persons employed in factories, mines and plantations and certain categories of railway workers, workers of mechanically propelled vehicles, construction works and certain other hazardous occupations. The Act suffers from poor implementation due to administrative difficulties.

2) **The Employees' State Insurance Act (ESIA) 1948:** The ESIA is the principal social insurance law in India. It applies to all workers in factories. The Act provisions an 'employee state insurance scheme' (ESIS) administered by the 'Employees State Insurance Corporation' (ESIC), an autonomous body. The coverage of the Act has been extended to shops, hotels, theatres, restaurants, and cinema and provides for medical care and cash benefits in the event of the death of a worker. The members of the deceased family of the insured persons (for permanent disablement and widow of the deceased) receive free and complete medical care for life.

3) **Employees' Provident Funds (and Miscellaneous Provisions) Act [EPFA] 1952:** The Act provides for compulsory contributory provident fund, including pension and insurance, for employees in factories and other establishments employing 20 or more persons. The Act provisions for three schemes viz. (i) Employees' Provident Funds Scheme, 1952, (ii) Employees' Deposit Linked Insurance Scheme, 1976 and (iii) Employees' Pension Scheme (EPS), 1995. The EPS, 1995, aims at providing economic sustenance during the old age and coverage for survivors. Under the EPS, pension at the rate of 50 percent of last drawn pay is payable to the employees on superannuation after completion of 33 years of contributory service.

4) **Maternity Benefit Act (MBA) 1961:** The Act aims to protect the earnings of women employees for a specified period of time both before and after child birth. The benefits under the Act are payable under three situations viz. childbirth, miscarriage and sickness arising out of pregnancy. Like other social security laws, the MBA also imposes

unilateral responsibility on the employer to pay maternity benefit to women employees covered. This Act has been amended in 2008 to provide for extension of the provisions of the MBA to women workers employed in shops and establishments employing 10 or more workers. An amended Maternity Benefit (Amendment) Act, 2017 extends certain benefits to adoptive mothers and provides entitlement of 12 weeks of maternity leave from the date of adoption.

5) **The Payment of Gratuity Act (PGA) 1972:** Gratuity is a benefit payable to the employees on superannuation from the service. Regulated by the PGA, it is a protection for organised sector workers working in factories, mines, plantations, shops and establishments, etc. employing 20 or more persons.

4.4.2 Unorganised Sector

The overwhelming majority in India's labour force works in the unorganised or informal sector, with low earnings and high social insecurity. Only 8 percent of India's labour force enjoy protection and social security of the organised sector. Realising this glaring lacunae, the GoI constituted a National Commission for Enterprises in the Unorganised Sector (NCEUS) in 2004. Following its recommendations, the government has enacted the Unorganised Workers Social Security Act in 2008. The Act stipulates formulation of welfare schemes for unorganised sector workers on matters relating to: (i) life and disability, (ii) health and maternity benefits, (iii) old age pension, etc. Various Schemes have since been formulated by the Government. These are: (i) Indira Gandhi National Old Age Pension Scheme, (ii) National Family Benefit Scheme, (iii) Janani Suraksha Yojana, (iv) Aam Admi Bima Yojana, (v) Rashtriya Swasthya Bima Yojana (a smart card based cashless health insurance scheme including maternity benefit) and (vi) Janashree Bima Yojna. Besides these, the government has also launched two more social security schemes for all citizens including unorganised workers. These are: Atal Pension Yojna and Pradhan Mantri Jeevan Jyoti Bima Yojana.

Shops and Establishments Act (SEA): While the above schemes are launched by the central government, there is a 'Shops and Establishments' legislation in India. Different states have formulated their laws applicable to 'shops and establishments' more or less on similar lines. Most workers who are employed in shops and establishments are in the unorganised sector (or informal sector) although there are certain larger establishments like motor transport companies, insurance companies, etc. Thus, the SEA covers larger as well as smaller shops and establishments.

4.5 RECENT LABOUR REFORM MEASURES

In a recent survey, medium-sized formal sector manufacturing firms reported labour regulations to be a significant barrier to growth specifically the 'dismissal norms under the Industrial Disputes Act' and the cumbersome nature of compliance with labour regulations. The multiplicity of labour laws and difficulty in complying with them has always been cited as an impediment to industrial development in India. The Economic Survey, 2016-17 states that at present there are 39 Central labour laws. Such numerous regulations encourage rent-seeking behaviour.

In a major initiative for ensuring compliance and promoting ease of doing business, the government has initiated a number of labour reform measures. Amendments have been proposed to labour laws to align them with the demands of a changing labour market with much of these left for the state government initiatives. Following this approach, individual states like Rajasthan have introduced labour reforms of a nature which removes the stringent provisions of the Act to make it easy for investors to do business. These fall in three labour legislations viz. the Industrial Disputes Act, Factories Act, and Contract Labour Act. For instance, Section 25 K of the IDA (regarding government permission required for retrenchment of workers) has been modified to raise the ceiling of number of persons employed to 300 workers. Likewise, Section 25 N of the IDA (requiring 3 months notice for retrenchment) has been modified as 'every worker retrenched shall be entitled to 3 months average pay as compensation' for retrenchment [in addition to 15 days payment for every completed year of service]. Earlier, this was 'three months notice or payment for 3 months in lieu of notice' and 'compensation equivalent to 15 days average pay for every completed year of service'. The amendment deletes the provision 'for payment of wages for the period of notice in lieu of notice' and modifies it as 'every worker at the time of retrenchment shall be entitled to an amount equivalent to his three months average pay in addition to the compensation for every completed year of service'. Similarly, Section 2 of the Factory Act has been modified to define a factory as 'employing 20 or more persons if using power and 40 or more persons if not using power'. The definition of 'establishment' under the CLA, 1970 is also modified to make the law applicable to establishments employing 50 or more contract workers (i.e. raising the ceiling from the 20 as per existing provision).

While the above modifications/amendments are the individual states' initiatives (i.e. by Rajasthan government), the following Labour Reform measures have also been initiated by the central government.

1) The Apprentice Act, 1961 was amended on 18.12.2014 to make it more responsive to industry and youth. An 'Apprentice Protsahan Yojana' was launched to support MSMEs in the manufacturing sector to engage apprentices. Government is also working affirmatively to bring a single

uniform law for the MSME sector to ensure operational efficiency and improve productivity while ensuring job creation on a large scale.

2) A unified labour portal scheme called 'Shram Suvidha Portal' has been launched for timely redressal of grievances and for creating a conducive environment for industrial development. Its main features are: (i) unique Labour Identification Number (LIN); (ii) filing of self certified, simplified single online return; (iii) transparent labour inspection scheme by uploading of inspection reports within 72 hours of labour inspection.

3) A digitisation of services to insured persons under the ESIA (under the banner of Panchdeep) to enable the checking of contributions paid/ payable by employers, entitlement of various benefits, status of claims, etc. to integrate all its services so as to curb transaction costs.

4) A digitisation programme of EPF subscribers with allotment of 'universal account number' (UAN) to each member to facilitate direct access to EPF accounts to enable members to view their account and disbursement details online. A minimum pension of Rs.1000 has been introduced for pensioners under the Employees' Pension Scheme, 1995 w.e.f. 1.9.2014.

5) A National Council for Vocational Training-Management Information System (NCVT-MIS) portal has been developed for streamlining the functioning of Industrial Training Institutes (ITIs), Apprenticeship Scheme, and assessment/certification of all NCVT training courses.

6) A National Career Service (NCS) is being implemented as a mission mode project to transform the National Employment Service to provide various job-related services such as online registration of job seekers and job vacancies, career counselling, vocational guidance, and information on skill development courses, internships and apprenticeship.

Check Your Progress 2 [answer within the space given in about 50-100 words]

1) State the scope of the Workmen's Compensation Act, 1923.

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2) Under which Act the old age pension needs of workers in factory are covered? What is the extent of coverage?

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3) Which social security legislation covers the smaller service sector establishments?

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4) What specific initiatives have been taken by the state governments in respect of labour reform measures?

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5) Identify the changes made by the Rajasthan government in the ID Act, 1947, indicating how this would amount to 'stimulating the demand for labour'?

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4.6 LET US SUM UP

Making a distinction of organised and unorganised sector workers, the unit has discussed the major labour laws on 'working conditions, employee relations, monetary benefits and social security provisions' for the organised sector workers. Observing that although the bulk of the workforce (close to 92 percent) are in the unorganised sector, no social security measures existed for them for a long time up to 2005, the unit then specifies some of the recent measures taken in this direction to meet their needs. More importantly, since the strict laws on retrenchment of workers that existed in Acts like the IDA, FA and CLA did not provide the required atmosphere for expansion of employment opportunities, the initiatives taken in amending these Acts by state initiatives have been illustrated in the unit. Some of the specific measures recently taken to simplify the administration of the existing Acts, which in their absence was making the whole process extremely difficult for the beneficiaries to access information and benefits, under the existing Acts like ESIA, EPFA, etc. have been specified.

4.7 KEY WORDS

Organised Sector	:	Refers to the sector in which employees of units/establishments are covered by laws of social security, conditions of work, payment norms, etc. Its opposite counterpart is the large unorganised sector where no such legal provision applies in the workers interest.
Unorganised ID Act, 1947	:	An Act to safeguard the interest of workers covered by the FA 1948 which defines a manufacturing unit as a 'factory' depending on the number of workers employed. In particular, the Act provides safeguard against untimely retrenchment from employment by the employer.
WC Act, 1923 & TU Act, 1926	:	WC Act is a legislation of 'social security' for the organised sector workers. TU Act is a legislation for providing a leverage in bargaining with the employers by allowing registration of workers' unions i.e. it is an Act meant to maintain 'employee relations' in situations of perceived exploitation of workers by the management. The two Acts are notable for being among the oldest of the legal legislations – the others having been enacted after the 1930s.

4.8 SOME USEFUL BOOKS AND REFERENCES

1) Basu, K. (2000). *Prelude to Political Economy: A Study of the Social and Political Foundations of Economics*. Oxford University Press, Oxford.

2) Basu, K. (2015). *An Economist in the Real World: The Art of policymaking in India*, Penguine Viking.

3) Chatterjee U, Murgai R and Rama M (2015). *'Job Opportunities along the Rural-Urban Gradation and Female Labour Force Participation in India,* Policy Research Working Paper 7412, World Bank.

4) Jain, A.K. (1980). *'Labour Policy in the Five Year Plans in India'*, Indian Labour Journal, Vol. 21, No. 2, February.

5) Saini, D.S. (2009). *'Labour law in India; Structure and Working'* In P. Budhwar and J. Bhatnagar (eds.), *Changing Face of HRM in India,* London: Routledge, 60-94.

4.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) For EMI, an organised sector unit is defined as 'all units in the public sector irrespective of their employment size' and 'those units in the private sector employing more than 25 persons compulsorily and voluntarily if employing 10-24 persons'. For ASI, an organised sector unit (factory) is defined as 'manufacturing units employing 10 or more persons if using power and 20 or more persons if not using power'.

2) The first amendment was in 1987 consequent to the Bhopal gas tragedy to strengthen the safety provisions and penalty for their violation. The second amendment was in 2005 and was to allow women workers to work in factories with safeguards instituted.

3) For not covering unorganised sector units and smaller factories/ units/establishments.

4) There has been an increase in the proportion of contract workers from about 12 percent in 1999 to 25 percent in 2010. This has made it acquire a new importance in the globalised economic atmosphere of current times.

5) The rationale is to provide immunity to registered trade unions and its members from withdrawing labour from exploitation and use the potential offered as a leverage in the bargaining process.

6) Its strength is that not even a single worker can be retrenched without the permission of the labour commissioner. The same clause has now become its weakness in so far as the Act has become a stumbling block in creating demand for labour.

7) It is not effective in implementing the Act to the large agricultural sector in the country. Even in urban areas, the smaller units evade the application of this law.

Check Your Progress 2

1) The Act covers persons employed in factories, mines and plantations and certain categories of railway workers, workers of mechanically propelled vehicles, construction works and certain other hazardous occupations.

2) The EPFA 1952 covers the old age pension needs of factory workers, including workers in other establishments employing 20 or more

workers. The pension is paid at 50 percent of last drawn pay wherever full service defined as 33 years is rendered.

3) Shops and establishments Act.

4) Rajasthan has made amendments in IDA, FA and CLA. The modification made includes: an increase in the ceiling of number of persons employed for factories covered under the IDA for seeking permission for retrenchment from 100 to 300; definition of factories under the FA to mean units employing '20 or more if using power' and '40 or more if not using power'; and CLA being applied for 'number of contract labour engaged' raised to 50 from 20.

5) Increasing the number of workers under the ID Act on retrenchment to apply makes it easier for smaller units to close down in cases of economic unviability of the unit. Since investors' sentiments is important for new units to come up and the old ones to be able to exit, without which the growth process would get stifled, this amendment is expected to boost the employment generation prospects particularly in the micro/small units sector.