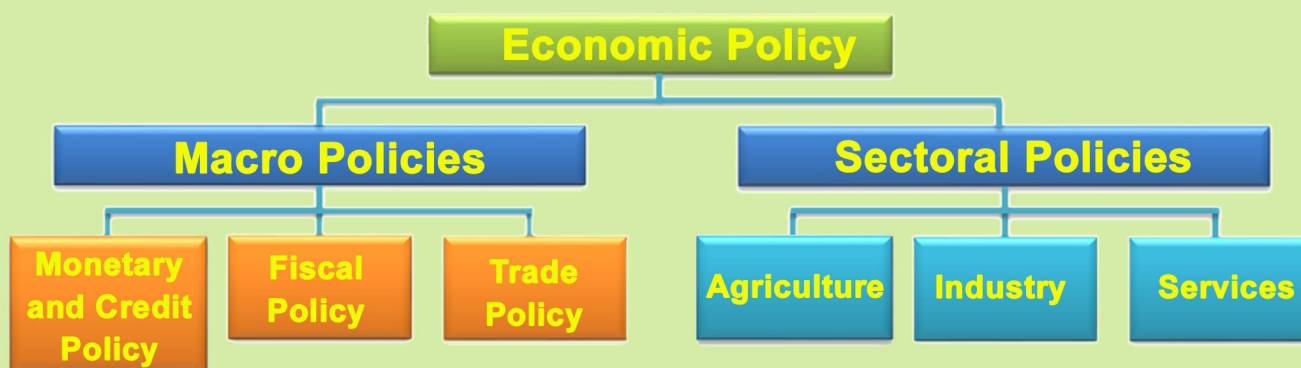




Issues of Concern

1. Poverty and Inequality
2. Unemployment
3. Regional Disparities
4. Malnutrition
5. Social Security
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VOLUME-II
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EXPERT COMMITTEE

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Former Director,
Indian Statistical Institute
New Delhi & Visiting Professor
Institute for Human Development
New Delhi

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Growth, New Delhi

Shri Saugato Sen
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Economics
IGNOU, New Delhi

COURSE COORDINATOR : Prof. Narayan Prasad

COURSE EDITOR : Prof. Rajeev Malhotra, Former Economic Advisor to Union Finance
Minister, Govt. of India

COURSE PREPARATION TEAM

Block/Unit Title	Unit Writer	Unit Editor
Block 3	Monetary and Fiscal Policies	
Unit 9	Inflation and Monetary Policy Mr. M. Rahul Dy. Director, Department of Economic Affairs, Ministry of Finance New Delhi	Prof Narayan Prasad & Ms. Chetali Arora
Unit 10	Capital Market and Its Regulations Dr. Alok Mishra University of Hyderabad Dr. Iti Mishra, ICAI, Hyderabad	Prof. Narayan Prasad
Unit 11	Fiscal Policy and Fiscal Responsibility and Budget Management (FRBM) Act Dr. Manish Gupta and Ms. Smriti Mehra, National Institute of Public Finance and Policy, New Delhi	Prof. Narayan Prasad & Ms. Chetali Arora
Unit 12	Major Development on Union State Relations Prof. Tapas Sen Rtd. Professor, National Institute of Public Finance and Policy, New Delhi	Prof. Narayan Prasad & Ms. Chetali Arora
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Unit 15	Micro, Small and Medium Enterprises (MSMEs): Issues and Policy Ms. Chetali Arora, Academic Associate IGNOU, New Delhi	Prof. Narayan Prasad
Unit 16	Services Sector I: Organised Sector- Issues and Policy Dr. J.C. Sharma Rtd. Sr. Economic Adviser Government of India	Prof. Narayan Prasad Ms. Chetali Arora
Unit 17	Services Sector II: Informal Sector- Issues and Policy Dr. J.C. Sharma Rtd. Sr. Economic Adviser Government of India	Prof. Narayan Prasad Ms. Chetali Arora

SECRETARIAL ASSISTANCE & GRAPHICS

Ms. Kamini Dogra
Personal Assistant
SOSS IGNOU, New Delhi

PRINT PRODUCTION

Mr. Yashpal
Assistant Registrar
IGNOU, New Delhi

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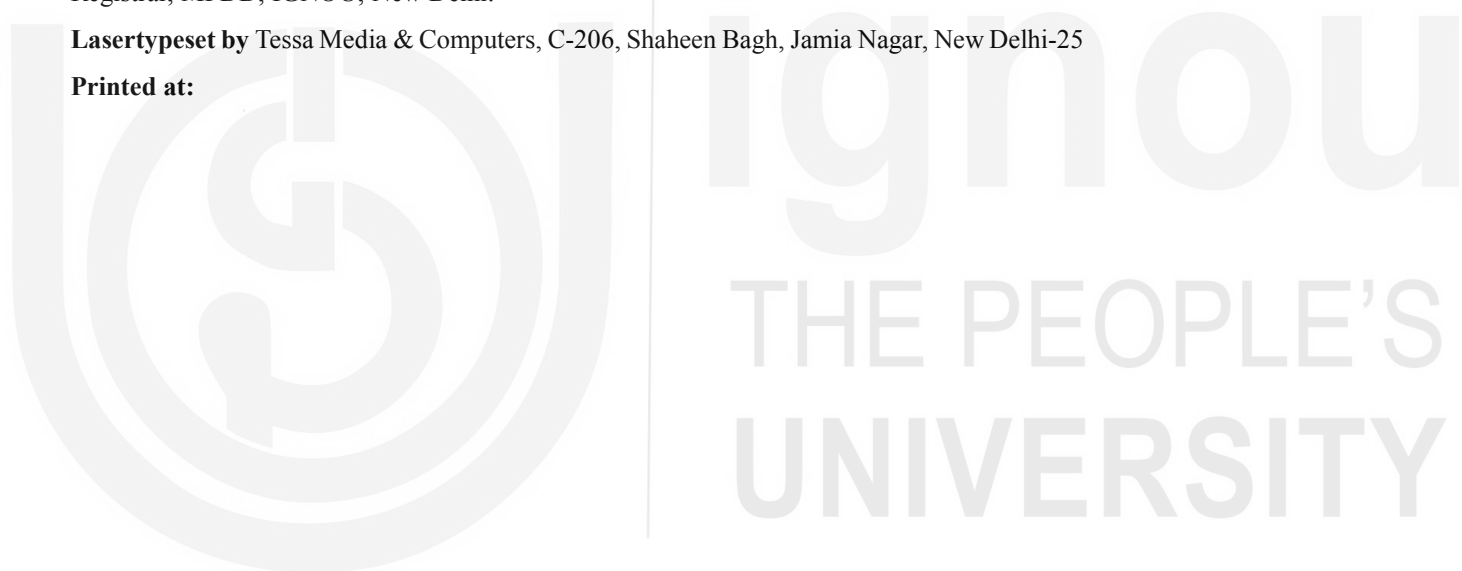
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BLOCK 3
MONETARY AND FISCAL POLICIES

BLOCK 3 MONETARY AND FISCAL POLICIES

Economic policies are statements of aims and ideals to be achieved through various policy instruments outlined by the government to guide the process of economic development. Broadly speaking, we can distinguish between two types of instruments of economic policy viz., Macroeconomic policies (or aggregate policies), and Microeconomic policies (Sectoral policies)

This block deals with two important instruments of macroeconomic policy:

1. Monetary Policy
2. Fiscal Policy

Apart from these two instruments, the block also deals with inflation, capital market and its regulation, fiscal responsibility and budget management (FRBM) Act.

Unit 9 entitled ‘**Inflation and Monetary Policy**’ throws light on inflation, its measurement factors influencing inflation, operating procedures and mechanisms involved in monetary policy.

Unit 10 on ‘**Capital Market and its Regulations**’ focuses on organisational structure, role, function and performance of Indian capital market, Indian equity market, currency market, derivative market and corporate debt market.

Unit 11 entitled ‘**Fiscal Policy and Fiscal Responsibility and Budget Management (FRBM) Act**’ examines how changes in government spending and taxation affect equilibrium level of income and interest rate in terms of IS-LM framework. The Unit also covers discussion on operation of fiscal policy, the need to adopt FRBM Act and appreciate the genesis of GST and its implementation.

Unit 12 on ‘**Major Development on Union State Relations**’ spells out the principles governing fiscal federalism, the role of Finance Commission as an institution in fiscal federalism, the recommendations of 14th and 15th Finance Commission and the dimensions and issues involved in contemporary Centre and state fiscal situation in the country.

UNIT 9 INFLATION AND MONETARY POLICY

Structure

- 9.0 Objectives
- 9.1 Introduction
- 9.2 Money
 - 9.2.1 What is Money?
 - 9.2.2 How Do We Measure Money?
- 9.3 Inflation
 - 9.3.1 What is Inflation?
 - 9.3.2 Inflation Measurement in India
 - 9.3.3 Costs of Inflation
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 - 9.5.1 Objectives of Monetary Policy in India
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- 9.6 Let Us Sum Up
- 9.7 Term-end Exercises
- 9.8 Key Words
- 9.9 References
- 9.10 Answers or Hints to Check Your Progress Exercises

9.0 OBJECTIVES

The purpose of this unit is to develop among learners an understanding of the framework and operating procedure of the monetary policy in India. After going through this unit, you will be able to:

- explain what money is and what inflation means and how money affects inflation;
- discuss what the instruments of monetary policy are;
- appreciate the evolution of monetary policy in India; and
- state the Inflation Targeting Framework in India.

9.1 INTRODUCTION

In this unit, we would be discussing inflation and monetary policy in India. Inflation is an economic issue that is a common topic of discussion for the public

as well as policymakers and researchers alike. It is an economic phenomenon that has a realisable impact on the daily lives of every citizen. You must have often heard your grandparents narrating stories about how, during their childhood, they were able to buy things for very small amounts of money compared to the present. They might remark that money has lost its value. Inflation, simply put, refers to the rate of increase in the prices of commodities during a given period. With a positive level of inflation, you are able to buy lesser amounts of goods and services using the same amount of money. Therefore, before we discuss inflation, it is important to understand what money is and how it affects the prices in the economy. We also discuss the monetary policy framework in India and see how it has evolved over the years, in sync with the requirements of the evolving economy.

9.2 MONEY

9.2.1 What is Money?

Money is something that we encounter in our daily lives. Despite this, it may be difficult for someone to define what money is or how it functions. Money is defined as anything that is generally acceptable as a medium of payment. Essentially, money serves three purposes:

- **It acts as a store of value:** Money can be a means to save a person's endowments, including labour, and used later for transactions. That is, income or wealth of individuals can be kept in the form of money and used for transactions in the future. It allows purchasing power to be taken forward from present to future. Thus, money acts as a store of value.
- **It acts as a unit of account:** Money acts as a common denominator on which all prices are measured. The value of goods and services exchanged in the economy is measured in terms of money.
- **It acts as a medium of exchange:** Since money has the above two features, it is generally acceptable as a means of payment for exchange of goods and services. Without money, any exchange in the economy would require a double coincidence of wants. That is, a transaction would take place only if both parties in the transaction had something that the other needed. With a generally acceptable means of payment, the need for double coincidence of wants is obviated by separating the transaction into two parts. First, the two parties engage in a transaction where one party gives money in exchange for the good or service he or she needs. In the second part of the transaction, the recipient of money in the first transaction uses the money to buy the goods or services that he or she requires.

Historically, many items have been used as money. Items with intrinsic value such as gold and silver were a form of money used for transactions in some societies. This form of money is called commodity money. Different societies have used everything from salt and grain to stones and precious metals as money at different points of time in history. Even in modern societies, commodities are known to have been used as a generally accepted means of payment. An interesting and often quoted example of commodity money is the use of cigarettes for transactions in Nazi prisoner of war camps during the second World War. The prevalent form of modern money is fiat money. Fiat money has no intrinsic value.

Its value is derived from a government order or a fiat. The coins and currency notes that we use in our daily lives are examples of fiat money.

9.2.2 How Do We Measure Money?

Any measure of the quantity of money should include the quantity of assets used in the economy for transactions. Currency notes and coins are obvious candidates for money. In addition to these, chequeable deposits may also be considered part of the money supply. In this manner, you may think of many other assets that could be considered for inclusion in the measure for money supply. It must therefore be clear to you that while defining money is a theoretical or conceptual matter, measuring money supply is an empirical question. RBI has the following measures of money supply:

Reserve Money (M0) = Currency in circulation + Bankers' deposits with the RBI
+ 'Other' deposits with the RBI

Narrow Money (M1) = Currency with the public + Demand deposits with the banking system + 'Other' deposits with the RBI

M2 = M1 + Savings deposits of post office savings banks

Broad Money (M3) = M1 + Time deposits with the banking system

M4 = M3 + All deposits with post office savings banks (excluding National Savings Certificates)

'Other' deposits with the RBI include deposits from foreign central banks, multilateral institutions, financial institutions and sundry deposits net of IMF Account No.1.

9.3 INFLATION

9.3.1 What is Inflation?

As you know, the price of a commodity refers to the amount of money you give in exchange for buying a unit of that commodity. The general price level refers to a measure of the overall price level in an economy. Inflation is the rate of increase in the general price level over a period of time. However, it is not straightforward to arrive at such a general price level, as in reality, such a measure does not exist. What we can do, at best, is to construct a measure that could be considered to represent this hypothetical value. To arrive at a single measure for the overall prices in the economy, we often look at a weighted average price of a basket of goods and services consumed by a representative consumer in the economy. This is achieved through the construction of a price index, which is a weighted average of price relatives of goods and services in a representative consumption basket. The changes in the price index over a given period reflect the changes in the prices of the goods and services in the consumption basket and therefore their growth rates are used as a measure of inflation.

9.3.2 Inflation Measurement in India

In India, two major types of price indices are used for calculation of inflation. These are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI). As the name suggests, CPI reflects the average retail price level as faced by the consumers. There are four measures of CPI in India. CPI (Rural, Urban and

Combined), CPI (Industrial Workers), CPI (Rural Labourers) and CPI (Agricultural Labourers). Table 9.1 gives more details about the price indices used in India. Out of these, the most important one is CPI-Combined, being used for monetary policy purposes. CPI, separately for rural and urban areas, have been estimated for a longer duration in India. The base year for CPI (Industrial Workers) was recently updated to 2016 from the earlier base of 2001. On the other hand, WPI reflects the price level for the first point of wholesale or bulk transactions. In India, WPI is taken as a proxy for producers prices (i.e. prices faced by producers), which unlike other countries are not estimated. The current WPI series has a base year of 2011-12. It is also calculated based on Laspeyres price index formula.

Table 9.1: Different Price Indices in India

Name of the Index	Base Year	Organisation Compiling the Index
CPI (Rural, Urban and Combined)	2012	National Statistical Office
CPI (Industrial Workers)	2016	Labour Bureau
CPI (Agricultural Labourers)	1986-87	Labour Bureau
CPI (Rural Labourers)	1986-87	Labour Bureau
WPI	2011-12	Office of Economic Adviser, Department for Promotion of Industry and Internal Trade

9.3.3 Costs of Inflation

Inflation is generally thought of as imposing hardships on the citizens. High inflation is thought to make goods and services unaffordable. However, if incomes rise at a rate that is at least as much as the rate of inflation, the goods and services would continue to remain affordable. However, there may be other, not so obvious, economic costs of inflation. One cost associated with high inflation is one that arises from the fact that people may choose to hold lower cash with themselves and keep a larger amount in the banks as deposits. This would mean frequent visits to the bank to withdraw money for their daily transactions. The inconvenience of frequently visiting the bank is dubbed as shoe-leather cost of inflation. With input prices frequently changing during a high inflation scenario, firms have to change the prices of their products frequently. The cost associated with frequently changing the posted prices is called the menu cost of inflation. As such, if frequent price changes are not synchronised, it may lead to the introduction of relative price distortions leading to inefficient allocation of resources in the economy. High inflation also introduces uncertainty into economic decisions. Firms and households may find it difficult to differentiate between relative and general price changes. Further, high inflation may lead to undesirable redistribution of income in the economy. Low-income households are usually dependent on wage payments and cash holdings for their day-to-day transactions. During a case of high inflation, cash holdings lose their real values quickly. If wages are not indexed to inflation, as may be the case in the informal sector, it may take a while before wages respond to increased prices. On the other hand, richer households which hold wealth in non-cash assets would not be affected as much. This means that high levels of inflation may widen the gap between the rich and the poor in the economy.

9.4 MONEY AND PRICES

9.4.1 Theoretical Perspectives on Money and Prices

Depending on the school of thought followed, the theory of how money supply affects prices and other economic variables varies. In the classical perspective, the price level was determined by the quantity of money in the economy. This view, called the *Quantity Theory of Money*, which was later revived by the Monetarist school, has been a dominant explanation for the relationship between money and prices. We can express this in the form of the *equation of exchange*:

$$M \times V = P \times Y$$

Where, M is the quantity of money, V is the income velocity of money – the number of times a rupee is used in transactions, that is the number of times on an average a rupee changes hand, P is the price level and Y is the output produced in the economy. Output being supply determined in the Classical view and the velocity of money determined by payment technology and institutional factors, being unchanged in the short-run, this identity says that an increase in the quantity of money would lead to a proportionate increase in the prices. Thus, with these assumptions, the equation of exchange translates into the quantity theory of money, explaining that the price level is determined by the quantity of money.

The equation of exchange can be represented in terms of growth rates by taking logs on both sides and differentiating with respect to time. We get,

$$\frac{1}{M} \frac{dM}{dt} + \frac{1}{V} \frac{dV}{dt} = \frac{1}{P} \frac{dP}{dt} + \frac{1}{Y} \frac{dY}{dt}$$

Which is nothing but,

Growth rate of money supply + Growth rate of velocity of money =
Inflation + Growth rate of output

Rearranging, we get,

Inflation = Growth rate of money supply + Growth rate of velocity of money –
Growth rate of output

With a stable velocity of money, growth in it is zero. Output is dependent on the factors of production. It is then straightforward that in the quantity theory of money, the inflation level is under the ultimate control of the monetary authority through the control on the quantity of money. The monetary authority can vary the inflation rate under this framework by varying the growth rate of money.

In the Keynesian perspective, money affects income via interest rates. An increase in money supply lowers the interest rate and stimulates aggregate demand and income. In an economy with excess capacity, higher aggregate demand should only lead to use of the earlier unused capacity in the economy and therefore should not lead to inflation.

In the late 1950s-60s, the Phillips Curve relationship came into the limelight, which provided a link between inflation and unemployment. According to this relationship, in the short-run there is a tradeoff between inflation and unemployment: an economy could achieve a lower unemployment rate by

stimulating demand in the economy at least in the short-run if it was willing to tolerate a higher level of inflation. In the long-run, however, this relationship is expected to breakdown as workers would want their wages adjusted to the higher rates of inflation and therefore, as a consequence, unemployment again rising.

9.4.2 Causes of Inflation

As we have seen above, the quantity of money is an important determinant of the level of inflation in the economy. The monetarist, Milton Friedman stated, “Inflation is always and everywhere a monetary phenomenon.” There is considerable agreement that, in the long-run money supply growth can be seen as a major determinant of inflation. In the short-run, however, fluctuations in the demand and supply conditions can have a major impact on the movement in the level of prices. Higher government spending, for example, can raise the level of aggregate demand in the economy and therefore put upward pressure on prices. This is an example of ‘demand-pull’ inflation. Another cause of inflation is increase in the costs of production due to increases in the costs of raw materials and other inputs. This is called ‘cost-push’ inflation. Sudden changes in supply conditions can alter the level of prices of the commodities concerned. You might have observed that years with deficient rainfall, prices of agricultural commodities witness sharp spikes. Insufficient rainfall affects production of agricultural commodities and therefore may lead to shortfall in the supply of these commodities, thus affecting the prices. These supply side factors are not generally expected to be affected by monetary policy.

For economic analysis, overall inflation (also called headline inflation) is usually divided into a “Core” part and a non-core part. Core inflation refers to that component of inflation that is long-term in nature. That is, Core inflation is calculated by separating out the volatile components of inflation that cause fluctuations in the short-term. These, in the context of a developing economy like ours, are usually components like food items that depend on seasonal and weather factors to determine their supply or fuel items that may be influenced by supply side shocks in the international markets. One would expect Core inflation to be more responsive to monetary policy than non-core inflation.

Check Your Progress 1

- 1) Consider an economy with a constant velocity of money. Money supply grows by 10 per cent per year and real income grows by 5 per cent per year. As per the Quantity Theory of Money that you have learnt above, what is the average rate of inflation?

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- 2) Download the yearly data on M3 (from average monetary aggregates) and nominal GDP of India (GDP at current prices) for years 2004-05 onwards from RBI’s Database on Indian Economy (<https://dbie.rbi.org.in/>). Now for each year, calculate the velocity of money by dividing the nominal GDP

for each year by the corresponding M3 number. Plot this as a line chart for these years. What trend do you observe in the velocity of money? What do you think are the reasons for the observed trend? What do you think would be the effect of greater number of digital transactions on the velocity of money?

9.5 MONETARY POLICY IN INDIA

9.5.1 Objectives of Monetary Policy in India

As the monetary authority of the country, the Reserve Bank of India formulates, implements, and monitors the monetary policy of the country. As per the Preamble of the Reserve Bank of India Act 1934, the primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. This is a direct consequence of its mandated function to “regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”. As we have seen, maintaining price stability is crucially dependent on the money supply in the economy. A high level of inflation may have an adverse effect on growth. Therefore, the objective is to maintain a low and stable level of inflation in the economy. Further, achieving high growth in the economy requires that credit flows to the most productive sectors of the economy.

9.5.2 Instruments of Monetary Policy in India

As the monetary policy framework has evolved over the years, the operating procedure of RBI's monetary policy has also evolved. RBI relies on a set of direct as well as indirect policy instruments to conduct its monetary policy. During the initial years, the focus of RBI was to regulate the demand and supply of credit through bank rate, reserve requirements and Open Market Operations.

As we have seen earlier, the need to finance government deficit dominated the monetary policy actions during the period between the 1950s and 1970s. Selective credit control mechanisms were used to channel credit to priority sectors. Between 1970 and 1990, the Statutory Liquidity Ratio (SLR), the share of net demand and time liabilities (NDTL) that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold, was increased several times. Within the period of 1980's, with a view to regulating liquidity and to provide resources for vital public sector investment within the framework of national priorities without generating reserve money, it was decided to increase the SLR. During the 1980s, a number of money market instruments such as inter-bank participation certificates (IBPCs), certificates of deposit (CDs) and Commercial Paper (CP) were also introduced.

Another important monetary policy instrument during the period was the Cash Reserve Ratio (CRR). The Cash Reserve Ratio (CRR) refers to the average daily balance that a bank is required to maintain with the RBI as a percentage of its Net demand and time liabilities (NDTL) that the RBI may notify from time to time in the Gazette of India. If the average daily balance held at RBI by a scheduled bank during any fortnight is below the minimum prescribed, the bank shall be liable to pay a penal interest on the amount of shortfall. CRR as a monetary policy instrument can be used to influence the money supply by the monetary

authority. An increase in CRR would lead the banks to have lesser amounts of money with them for lending with the same amount of deposits. This would reduce the amount of credit created and therefore reduce the money supply through the money multiplier process. In the 1980's the CRR was changed in different time periods as one of the important policy measures.

With liberalisation in the Indian economy and the financial sector reforms, there was a shift from direct to indirect, market based policy instruments. In the period 1990-91, the Narasimham committee had recommended that the CRR should continue to be used as an instrument of monetary control. But it was recognised that the existing levels were high and needed to be brought down. The year 1996-97 was significant in many ways in relation to the conduct of monetary policy in India. It was the first time the CRR was reduced sharply by 4 percentage points within a financial year in the five phases. The CRR was brought down to 9.5 per cent and SLR to 25 per cent by 1997. The process of deregulation of interest rates was also initiated in the early 1990s simplifying the complex structure of deposit and lending interest rates.

Following the Narasimham Committee-II Report (1998), the Interim Liquidity Adjustment Facility (ILAF) was introduced in April 1999, to determine the corridor for money-market rates. With subsequent revisions, the revised Liquidity Adjustment Facility (LAF) was announced in October 2004 and has now emerged as the principal operating instrument of monetary policy. The LAF consists of overnight as well as term repo auctions. Repurchase agreements, called repo (repurchase options) or reverse repo are agreements in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing. Under a repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a repo when viewed from the perspective of the seller of the securities and reverse repo when viewed from the perspective of the buyer of the securities. Under the LAF, the repo rate is the rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF). On the other hand, the rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF is called the reverse repo rate.

With the LAF, repo rate has become the single independent policy rate. The reverse repo rate is placed below the repo rate. Under the LAF, a Marginal Standing Facility (MSF) was also instituted. MSF is a facility under which scheduled commercial banks can borrow additional amounts of overnight money from the RBI at a penal rate of interest. The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate with the repo rate in the middle of the corridor (Figure 9.1). The LAF operates through daily repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with the policy objectives.

In the current monetary operating framework, reliance on direct instruments of monetary policy has been reduced and liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and repo and reverse repo operations

under Liquidity Adjustment Facility (LAF). The LAF enables RBI to modulate short-term liquidity under varied financial market conditions in order to ensure stable conditions in the overnight (call) money market.

Bank rate is the rate at which RBI is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Market Stabilisation Scheme (MSS) is an instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through the sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

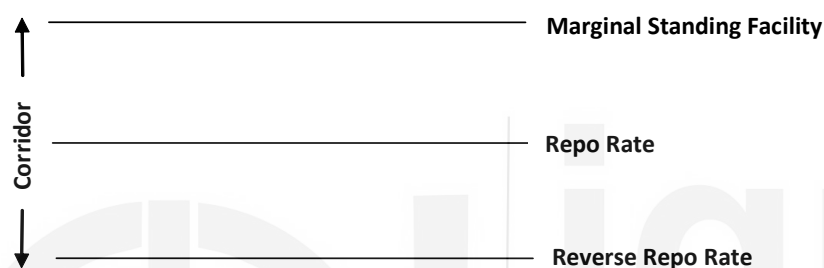


Fig. 9.1: The Liquidity Adjustment Facility Framework

9.5.3 Monetary Policy Transmission

Monetary policy transmission is the process through which monetary policy affects the ultimate policy target. That is, it is the process through which a change in the policy rates by RBI, through changes in lending rates of banks, deposit rates, asset prices and economic activities, ultimately affects the inflation rate. As such, it is a complex process involving uncertainty in the channel, quantum, and timing of impact.

Monetary policy acts through influencing the cost and availability of credit. A change in RBI's policy rate, through its impact on the short-term interest rates and further on rates of longer-term instruments, affects the cost of funds for banks. This would affect the rate at which banks would be willing to lend as well as the rate that they would be willing to offer their depositors. For example, a reduction in the policy rate leads to a lower cost of funds for the banks and therefore lower lending rates. This would induce households and businesses to avail greater credit from the banks and thus boost the aggregate demand in the economy. The higher demand in the economy would put upward pressure on wages and prices. Lower interest rates also boost the demand for assets and thus increasing their prices. Higher asset prices imply greater wealth for the asset owners and therefore may lead to greater spending in the economy, thus again boosting the demand and pushing overall prices up. Lower interest rates could also impact inflation through the exchange rate channel. Lower interest rates imply lower returns for foreign investors and therefore may lead to capital flight from the country. This would cause the currency to depreciate. This means that imports are much more costlier now compared to earlier, causing prices to go up.

The effectiveness of monetary policy essentially depends on the institutional framework available for transmitting impulses released by the central bank. It

has been observed that monetary policy transmission in India has been slow and generally incomplete. India has a financial system dominated by commercial banks. A major part of the total liabilities is in the form of deposits. A large number of deposits have maturity over one year meaning that the changes in policy rates would only impact new deposits. High NPAs have also impacted the profitability and liquidity of the banks affecting the transmission process.

9.5.4 Evolution of Monetary Policy in India

The approach to monetary policy has been evolving over the years as per the requirements of a dynamic economy since the inception of RBI as the country's central bank in the year 1935. Overall price stability and growth have been the broad guiding principles of monetary policy. RBI was nationalised in 1949 and Banking Regulation Act was enacted the same year. The latter required the banks to maintain a Statutory Liquidity Ratio (SLR) as a percentage of their net time and demand liabilities in the form of cash, gold or approved securities (Mohanty, 2017). During the initial decades after independence of the country, the role of RBI was to support the developmental efforts of the government by ensuring adequate flow of credit to the priority sectors of the economy. Owing to the primacy of public investment in the development policy during this period, there was persistent deficit financing. Issuance of ad-hoc treasury bills by the government leading to automatic monetisation of deficits, as well as ensuring flow of funds from banks through higher SLR were the main modes of financing Government deficits. The monetisation of deficits, war with Pakistan in 1971, oil price shocks during 1973 and 1979, as well as droughts in 1973 and 1979 led to high inflation during the 1970s (Mohanty, 2017). Inflation increased from 10 per cent in 1972-73 to 25 per cent in 1974-75.

The Sukhamoy Chakravarty Committee formed in 1982 to assess the working of the monetary system, recommended primacy of price stability in monetary policy. Chakravarty Committee recommended a monetary targeting framework. Between the 1980s and late 1990s, a monetary targeting framework was followed by the RBI for monetary policy. Development and price stability continued to be the primary objectives of monetary policy. Under this framework, broad money (M3) was the intermediate target of monetary policy.

As you would know, the 1990s was a decade of many broad-based and transformative reforms in the Indian economy. Due to the developments and reforms in the financial sector, indirect instruments such as interest rates had started gaining effectiveness as transmitters of policy signals. Liberalisation in the financial markets made money demand unstable. Further, due to the greater integration of the Indian economy with the global economy and the ensuing inflow of foreign capital made it difficult to completely control the money supply. Due to these reasons, RBI shifted to a "Multiple Indicators" approach in 1998-99. Under this approach, Monetary policy was formulated based on a wide set of variables and more emphasis was put on the rates channel for monetary policy (Mohanty, 2011).

In September 2013, RBI set up an expert committee headed by its then Deputy Governor, Dr. Urjit Patel, with a view to strengthen the monetary policy framework while among other things, making it transparent and predictable. It recommended that inflation should be set as the nominal anchor for monetary policy framework and that it should be set as the predominant objective of

monetary policy. A nominal anchor is a variable that policy makers can use to “tie down” price level or its path (Mishkin, 1999).

Inflation expectations play an important role in shaping price behaviour. Therefore, the ideal nominal anchor should be able to track inflation expectations. The Committee recommended CPI-Combined headline inflation as the inflation indicator for monetary policy. According to the committee, in the post-2011 period, inflation expectations had been following CPI inflation and was affected by both fuel and food inflation. Therefore, CPI headline inflation was the appropriate target for monetary policy.

Table 9.2: Monetary Policy phases in India

1950s to 1980s	1980s to 1998	1998 to 2016	2016 to Present
Developmental Central banking and Credit Planning & Targeting Credit planning	Monetary Targeting Broad money (M3) as an intermediate target and Reserve Money (M0) as operating target	Multiple Indicators Approach Multiple indicators including interest rates, broad money, credit by banks and financial institutions, capital flows, inflation rate etc.	Flexible Inflation Targeting CPI inflation target (currently of 4 per cent $\pm$ 2 per cent band)

9.5.5 Inflation Targeting Framework

What Urjit Patel Committee (RBI, 2014) recommended was a framework for monetary policy is called the Flexible Inflation Targeting framework. Various economies globally have followed inflation targeting since the late 1980s. An inflation targeting regime follows a monetary policy framework with a mandate for price stability through a numerical target for inflation. This brings in greater transparency and accountability into the operation of monetary policy as well as greater operational independence for the monetary authority. The Government of India and RBI entered into a Monetary Policy Framework Agreement on 25th February, 2015 which required RBI to bring inflation below six per cent by January 2016 and the target inflation for 2016-17 and all subsequent years as 4 per cent with a band of $\pm$ 2 per cent. The RBI Act 1934 was amended in May 2016 to introduce Flexible Inflation Targeting Framework in India. The Government of India notified a medium-term inflation target of 4 per cent with a band of $\pm$ 2 per cent for the period from August 5, 2016 to March 31, 2021. RBI would be deemed to have failed in achieving the target if the inflation in any consecutive three quarters is either above 6 per cent or below 2 per cent. In case of failure to meet the target, RBI is required to present a report to the Central Government detailing the reasons for the failure to meet the target, remedial actions proposed to be taken by RBI and the estimated time in which the target would be achieved through the recommended actions. RBI is also required, once every six months, publish a Monetary Policy Report, explaining (a) the sources of inflation; and (b) the forecasts of inflation for the period between six to eighteen months from the date of publication of the document.

A Monetary Policy Committee (MPC) was instituted to determine monetary policy. For this purpose, the Reserve Bank of India Act, 1934 was amended by

the Finance Act, 2016. MPC consists of six members, out of which three members are from RBI and the other three are appointed by the Central Government as notified by the Central Government. The composition of MPC as follows:

- a) the Governor of the Bank– ex officio Chairperson;
- b) Deputy Governor of the Bank, in charge of Monetary Policy– ex officio Member;
- c) one officer of the Bank to be nominated by the Central Board– ex officio Member; and
- d) three persons to be appointed by the Central Government– Members.

The MPC is to meet at least 4 times in a year. The quorum for a meeting of MPC is four of which at least one is to be the Governor and, in his absence, the Deputy Governor who is a Member of the MPC. MPC determines the policy rate in order to achieve the inflation target. Decisions are based on majority votes by the members of the MPC present in the meeting. Each Member of the Monetary Policy Committee has one vote. In case of a tie of votes, the Governor may have a second or casting vote to resolve the tie. After each meeting of MPC, RBI publishes the resolution adopted by the Committee. On the 14th day, the minutes of the proceedings of the MPC are published.

Check Your Progress 2

- 1) In your opinion, is inflation targeting an appropriate monetary policy regime for a developing country like India? Why or why not?

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- 2) Look at the latest available Bi-monthly Monetary Policy Statement – Resolution of the Monetary Policy Committee (MPC). What is the decision of the MPC with respect to the repo rate? What is the assessment made by MPC on the growth and inflationary outlooks for the economy? How do you think these assessments have influenced the decision on the policy rate?

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9.6 LET US SUM UP

In this unit, we have looked at the concepts of money and inflation and the link between the two. After going through the unit, you would now be able to analyse the current trends in inflation and understand the causes of inflation from an

economic perspective. We have also looked at the objectives of monetary policy in India, its instruments and how it has evolved over the years. Over the years, RBI has moved from direct to indirect instruments for monetary policy. You would realise that the developments in monetary policy framework in the country has paralleled the overall liberalisation and modernisation efforts in the rest of the economy. The current monetary policy framework in India is the flexible inflation targeting framework with a numerical target of 4 ± 2 per cent inflation.

9.7 TERM- END EXERCISES

- 1) What is money and what functions does it serve? Which of these functions do the following satisfy and which they do not?
 - a) Gold coins
 - b) A credit card
 - c) A painting by M.F. Hussain
 - d) A fixed deposit
- 2) What is inflation? How is it measured in India?
- 3) What are the costs of inflation? Do you think there are any benefits to inflation? Why do we not want zero inflation?
- 4) What is the Quantity Theory of Money and how does it explain the relationship between money growth and inflation?
- 5) What are the objectives of monetary policy in India? How has the monetary policy evolved? What is the current monetary policy framework in the country?
- 6) What are the monetary policy instruments used by the Reserve Bank of India?

9.8 KEY WORDS

Money	: Money is anything that is generally accepted as a medium of exchange. Apart from being a medium of exchange, it serves as a unit of account and a store of value.
Inflation	: The rate of increase in the general price level over a period of time. It is measured usually in terms of the growth in a price index such as the Consumer Price Index.
Statutory Liquidity Ratio	: The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
Open Market Operations	: These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

Market Stabilisation Scheme	: This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through the sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.
Bank Rate	: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.
Cash Reserve Ratio	: The Cash Reserve Ratio (CRR) refers to the average daily balance that a bank is required to maintain with the RBI as a percentage of its Net demand and time liabilities (NDTL) that the RBI may notify from time to time.
Reverse Repo	: The rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.
Liquidity Adjustment Facility	: The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors.
Marginal Standing Facility	: A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

9.9 REFERENCES

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- 6) RBI 2014, “*Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework*” January 2014, Reserve Bank of India
- 7) Reserve Bank of India Act, 1934 (As amended by the Finance (No. 2) Act, 2019)
- 8) Viral Acharya 2017, “*Monetary Transmission in India: Why is it important and why hasn't it worked well*”, Inaugural Aveek Guha Memorial Lecture November 2017, Tata Institute of Fundamental Research (TIFR)

9.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Sub-section 9.4.1
- 2) See Sub-section 9.4.1

Check Your Progress 2

- 1) A useful reference could be “*Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework*” which can be downloaded from the RBI website.
- 2) See the RBI website for the latest monetary policy statement.

UNIT 10 CAPITAL MARKET AND ITS REGULATIONS

Structure

- 10.0 Objectives
- 10.1 Introduction
- 10.2 Role, Significance and Function of Capital Market
- 10.3 Stock Market Development in India
- 10.4 Structure and Performance of Indian Stock Market
- 10.5 Equity Derivatives in India
 - 10.5.1 Exchange-Traded and Over-the-Counter Derivative Instruments
- 10.6 Currency Derivative Market in India
- 10.7 Long-Term Government Bond and Corporate Debt Market in India
 - 10.7.1 Outlook for Development of Corporate Debt Market
- 10.8 Let Us Sum Up
- 10.9 Term-End Exercises
- 10.10 Key Words
- 10.11 References
- 10.12 Answers or Hints to Check Your Progress Exercises

10.0 OBJECTIVES

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

- develop an understanding of the organisational structure, role, function and performance of the Indian capital market;
- explain the radical restructuring of the Indian capital market in the wake of the new economic policy in 1991; and
- discuss the role, function and structure of Indian Equity Market, Currency Market, Derivative Market and Corporate Debt Market.

10.1 INTRODUCTION

A dynamic and efficient financial system plays a pivotal role in any economy for efficient allocation of resources from the surplus segments to deficit segments. The financial system consists of financial markets, financial intermediation and financial products or instruments. A thriving and vibrant economic system requires a well developed financial structure with multiple intermediaries operating in the market with different risk profiles. Further, a financial system helps to increase output by moving the economic system towards the production frontier. This involves transforming a given amount of wealth into more productive forms. It induces public and investors to hold lower saving in the form of precious metals, real estate, land, consumer durables and idle cash balances and to replace these assets by financial instruments such as bonds, shares, preference shares, units etc. As a result a financial system helps to increase the volume of productive

investments. It encourages investment activity by reducing the cost of finance and risk. This is done by providing insurance services and hedging opportunities and by making financial services such as remittances, discounting, acceptance, and guarantees available. Finally, it not only increases greater investment but also raises the level of resource allocational efficiency among different investment channels. The broad picture of the Indian Financial System is presented in the schematic diagram as Figure 10.1. The financial system in India is characterised by progressive liberal policies, vibrant equity and debt markets and prudent banking norms.

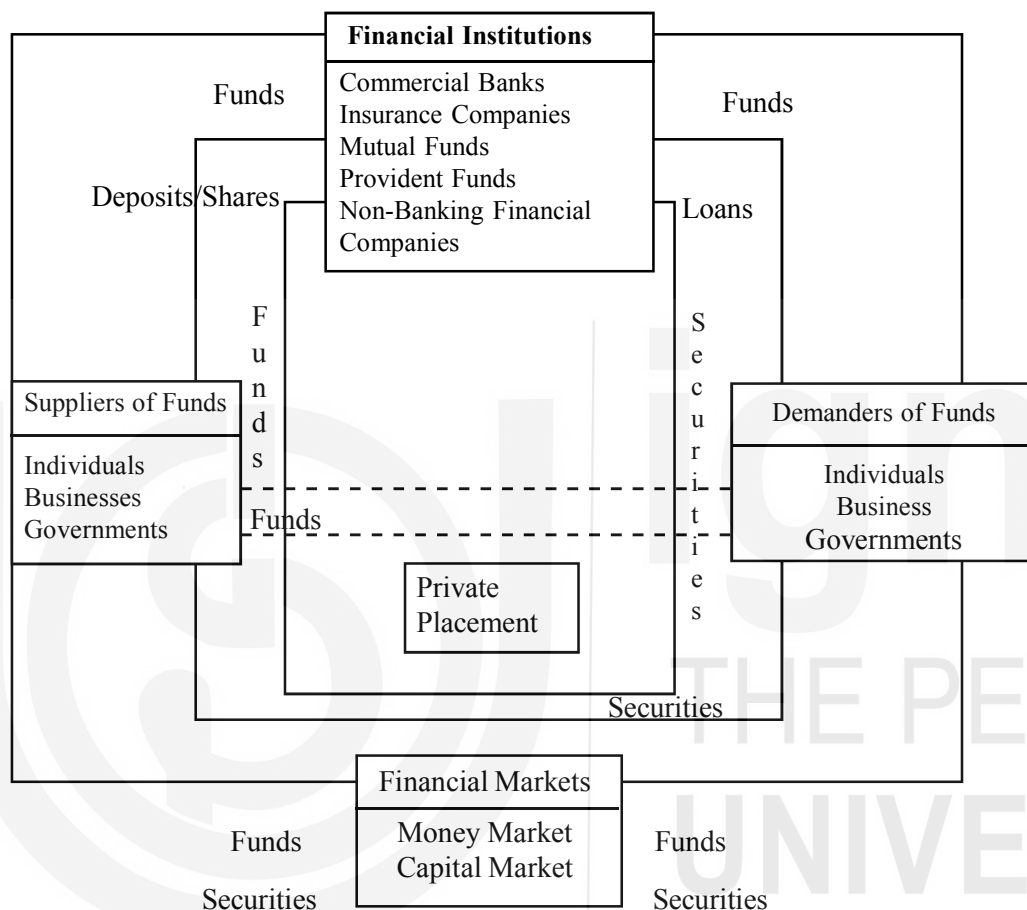


Fig.10.1: Indian Financial System

Source: Author

Capital market is an integral part of the financial market. The capital market is a market for financial assets which have a long or indefinite maturity. Capital market is broadly categorised into two parts such as primary and secondary market. In the primary market, new stock or bond issues are sold through a mechanism popularly known as underwriting. In the secondary market shares that have been issued are traded through organised exchanges such as stock exchanges, over the counter, etc. The capital market consists of stock or equity market, debt market, derivative market, foreign exchange market and commodity market. These markets are providing the facilities for buying and selling of the variety of financial claims and services. The corporations, financial institutions, individuals, and governments trade in financial products on these markets either directly or through brokers and dealers on organised exchanges or off exchanges. The capital market participants on the demand and supply sides of these markets are financial institutions, agents, banks, brokers, dealers, lenders, savers and others who are interlinked by the laws, contracts, covenants, and communication networks. The

primal role of the capital market is to channelise investments from investors who have surplus funds to the ones who are running a deficit. Financial regulator such as the Security Exchange Board of India (SEBI) oversees the capital markets in their designated jurisdictions to ensure that investors are protected against fraud among other duties.

Reforming and liberalising financial markets began in the wake of the country's 1991 balance-of-payments crisis. The thrust of these reforms was to promote a diversified, efficient and competitive financial system, with the ultimate objective of improving the allocation of resources through operational flexibility, improved financial viability, and institutional strengthening. The pace of reform was, however, slower than those in product markets, partly because the introduction of stricter prudential controls on banks revealed significant problems in asset portfolios. Prior to the reforms, state-owned banks controlled 90 per cent of bank assets— compared with approximately 10 per cent at end-2005— and channelled an extremely high proportion of funds to the government. Interest rates were determined administratively; credit was allocated based on government policy and approval from the Reserve Bank of India (RBI) was required for individual loans above a certain threshold. Capital markets were underdeveloped, with stock markets fragmented across the country. The major stock market acted mainly in the interest of its members, not the investing public. Derivative markets did not exist and comprehensive capital controls meant that companies were unable to bypass domestic controls by borrowing abroad. Concerns over the 1997-98 Asian financial crisis and its contagion effects further spurred Indian authorities to strengthen the domestic financial system. Reforms were, and continue to be, based on several principles: (i) mitigate risks in the financial system; (ii) efficiently allocate resources to the real sector; (iii) make the financial system competitive globally, and (iv) open the external sector. The goal was to promote a diversified, efficient, and competitive financial system which would ultimately improve the efficiency of resource allocation through operational flexibility, enhanced financial viability, and institutional strengthening.

The economic impact of COVID-19 is shaping up to be significant, however uneven, across the Indian financial markets. Major structural economic reforms in India such as demonetisation on 8th November 2016 and implementation of Goods and Services Tax on 1st July 2017 poses a major challenge on Indian equity market and foreign exchange market. The outbreak of global COVID-19 pandemic crisis has impacted the Indian economy, like others, by restricting people, minds, innovations, goods and services. This has reflected in terms of reduction in consumption demand, production and supply chain management, investments, worsening of unemployment, reduction in the volume and receipts of exports and imports, consequently a reduction in the growth rate.

10.2 ROLE, SIGNIFICANCE AND FUNCTION OF CAPITAL MARKET

The capital market facilitates the transfer of capital (financial) assets from savers to investors. It provides a significant amount of liquidity which refers to how easily an asset can be converted to currency without loss of value. The major functions of the capital market include efficient dissemination of information enabling quick valuation of financial instruments, providing insurance against market risk and price risk, enabling broad-based participation, providing

operational efficiency through simplified transaction procedures, lowering settlement timings and lowering transactional costs. Apart from these, the capital market plays a vital role in advancing integration between real and financial sectors, equity and debt instruments, long-term and short-term funds, private sector and government sector, and domestic and external funds. It also speeds up growth and development by directing the flow of funds into efficient channels through investment, disinvestment and reinvestment. Thus the various roles of the capital market contribute to mobilisation of savings and acceleration of capital information, promotion of industrial growth, raising of long-term capital, provision of a variety of services, and efficient and optimum channelisation of funds.

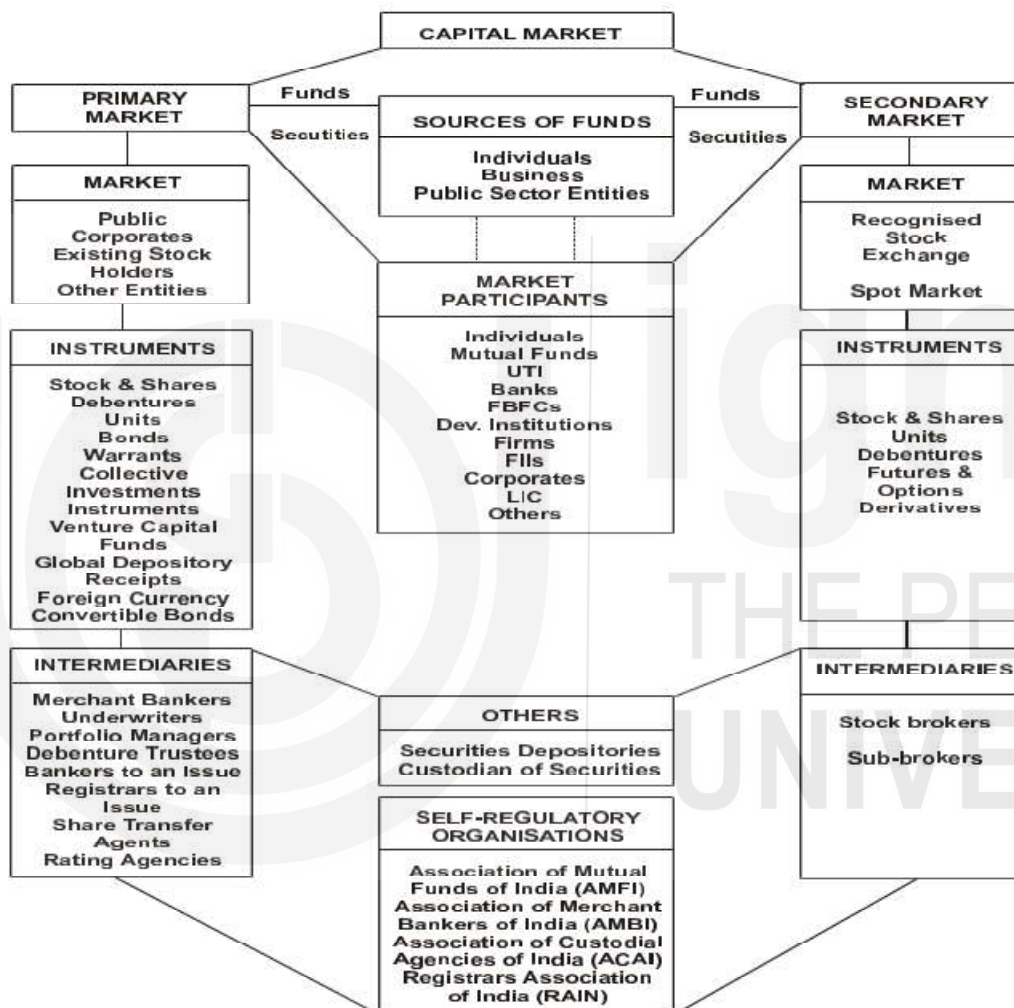


Fig. 10.2: Components of Indian Corporate Securities Markets

Source: Author

Check Your Progress 1

1) What are the constituents of financial system?

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- 2) Who are the different participants in a capital market?

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- 3) List the major functions of a capital market.

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10.3 STOCK MARKET DEVELOPMENT IN INDIA

To understand the role of a stock market in the process of the socio-economic development process, let's start with posing a question: why do stock markets exist? Why is it important? In common parlance, a stock market is defined as a public market where investors can buy and sell shares on the stock exchange. The stocks are also known as common stock or equities and represent a fractional ownership of the business in a company, firm or industries. Stock markets have existed for centuries. Since its inception, the stock market has served multiple purposes. The most important being to provide the companies with a means to raise capital for investment and operational expansion. It also helps investors/savers earn a return on their savings when they invest in the stock market and allows firms to spread their risk by diversifying their business across sectors, assets, industries, and geographies. This way of raising capital can help companies to expand their operation alongside the creation of jobs in the economy. From the larger perspective of economics, the increase in employment increases purchasing power and therefore consumer spending, production and improves supply chain management. The government benefits from tax revenues to advance provisioning of public goods and thus economic growth and development. Apart from conducive fiscal and monetary policies, a stock market plays a pivotal role to promote investment activity in an economy.

A developed stock market is considered as the major barometer of economic growth because (a) it provides an additional channel (along with banks and financial institutions) for encouraging and mobilising domestic savings, (b) ensures improvements in the productivity of investment through the market allocation of capital, (c) increases managerial discipline through the market for corporate control. In brief, the various indicators of stock market development are Market Capitalisation Ratio (MCR)¹, which is considered as a measure of stock market size. In terms of the economic significance, market capitalisation as a proxy for the market size is positively related to the ability to mobilise

¹ The MCR is defined as the value of listed shares divided by GDP.

capital and diversify risk. The next major indicator is market liquidity, which is measured by value-traded ratio and turnover ratio. Value traded ratio equals the total value of traded shares in the stock market divided by GDP. While, in turn, turnover ratio is the value of total shares traded divided by market capitalisation. The next important indicator of stock market development is the volatility parameter, which conceptualises the asset price movement in a stock market and conveys important signals for its development.

The average value of market capitalisation ratio (MCR) for India from 2003 to 2019 was 76.26 per cent. The minimum MCR was 45.93 per cent in 2003 and the maximum was 149.51 per cent in 2007. In the latter part of 2007, the US subprime lending crisis broke out and in no time it became a global economic crisis. Due to this, the MCR fell drastically to 53.98 per cent. In the wake of demonetisation undertaken by the Central Government on 8th Nov 2016, MCR declined to 68.27 per cent from 72.08 per cent in 2015. Moreover, with the advent of Goods and Service Tax (GST) on 1st July 2017, the MCR increased to 87.89 per cent and then declined to 75.81 per cent in 2019 and continued on a declining trend subsequently because of COVID-19 pandemic. The stock market turn over ratio (TOR) was 68.25 per cent on an average from 2003 to 2019. In 2003, the TOR was 94.47 per cent. It had grown to 142.99 per cent during the global financial crisis period in 2008. However, in the demonetisation period of 2016, it declined to 51.18 per cent and further to 50.87 per cent during the GST period in 2017. It increased to 58.07 per cent in the post GST period in 2018 and then declined to 28.89 per cent in 2019 and continued the trend during COVID-19 pandemic period. The average value of the stock market value traded ratio (VTR) was 51.96 per cent with a minimum of 28.96 per cent in 2013 and a maximum of 93.97 per cent in 2007. It declined to 77.19 per cent in 2008 on account of the global financial crisis and further to 34.94 per cent in 2016 because of demonetisation before recovering to 44.71 per cent in 2017. Finally, the average value of the stock price volatility from 2003 to 2017 was 21.83 per cent. The minimum was 12.76 per cent in 2017 and a maximum of 43.74 per cent in 2009.

10.4 STRUCTURE AND PERFORMANCE OF INDIAN STOCK MARKET

There are 23 stock exchanges in India, the first being the Bombay Stock Exchange (BSE), which began formal trading in 1875, making it one of the oldest in Asia. In 2010, the number of stock exchanges in India reduced to 19 as the Magadh, Mangalore, Hyderabad and Saurashtra Kutch stock exchanges have been derecognised by the market watchdog SEBI. As of Jan 17, 2020 the total number of recognised stock exchanges in India has reduced to 9 (see Table 10.1) as the Hyderabad Securities and Enterprises Ltd (erstwhile Hyderabad Stock Exchange), Coimbatore Stock Exchange Ltd, Saurashtra Kutch Stock Exchange Ltd, Mangalore Stock Exchange, Inter-Connected Stock Exchange of India Ltd, Cochin Stock Exchange Ltd, Bangalore Stock Exchange Ltd, Ludhiana Stock exchange Ltd, Gauhati Stock Exchange Ltd, Bhubaneswar Stock Exchange Ltd, Jaipur Stock Exchange Ltd, OTC Exchange of India, Pune Stock Exchange Ltd, Madras Stock Exchange Ltd, U.P. Stock Exchange Ltd, Madhya Pradesh Stock Exchange Ltd, Vadodara Stock Exchange Ltd, Delhi Stock Exchange Ltd and Ahmedabad Stock Exchange Ltd have been granted exit by SEBI.

Table 10.1: List of Stock Exchanges in India (As of Jan 2020)

S. No.	Name of the Recognised Stock Exchanges	Segments Permitted Valid upto	Recognition
1.	Bombay Stock Exchange Limited, Mumbai	a. Equity b. Equity Derivatives c. Currency Derivatives (including Interest Rate Derivatives) d. Commodity Derivatives e. Debt	Permanent
2.	Calcutta Stock Exchange Ltd		Permanent
3.	India International Exchange (India INX), Gujarat	a. Equity Derivatives (Equity Index Derivatives & Single Stock Derivatives) b. Commodity Derivatives c. Currency Derivatives d. Debt	28-Dec-20
4.	Indian Commodity Exchange Limited, Navi Mumbai	Commodity Derivatives	Permanent
5.	Metropolitan Stock Exchange of India Ltd., Mumbai	a. Equity b. Equity Derivatives c. Currency Derivatives (including Interest Rate Futures) d. Debt	15-Sep-20
6.	Multi Commodity Exchange of India Ltd., Mumbai	Commodity Derivatives	Permanent
7.	National Commodity & Derivatives Exchange Ltd., Mumbai	Commodity Derivatives	Permanent
8.	National Stock Exchange of India Ltd., Mumbai	a. Equity b. Equity Derivatives c. Currency Derivatives (including Interest Rate Derivatives) d. Commodity Derivatives e. Debt	Permanent
9.	NSE IFSC Ltd., Gujarat	a. Equity Derivatives (Equity Index Derivatives & Single Stock Derivatives) b. Currency Derivatives c. Commodity Derivatives d. Debt Securities (Masala Bonds)	Permanent

Source: SEBI

Note: India International Exchange Ltd and NSE IFSC Ltd have Single Segment across all asset/product classes.

Before 1994, India's stock markets were dominated by BSE. In other parts of the country, the financial industry did not have equal access to markets and was unable to participate in forming prices, compared with market participants in Mumbai (Bombay). As a result, the prices in markets outside Mumbai were often different from prices in Mumbai. These pricing errors limited the order flow to these markets. Explicit nationwide connectivity and implicit movement toward one national market have changed this situation (Shah and Thomas, 1997). NSE has established satellite communications which give all trading members of NSE equal access to the market. Similarly, BSE and the Delhi Stock Exchange are both expanding the number of trading terminals located all over the country. The arbitrages are eliminating pricing discrepancies between markets.

Over the last few years, there has been a rapid change in the Indian securities market, especially in the secondary market. Advanced technology and online screen-based transactions have modernised the stock exchanges. In terms of the number of companies listed and total market capitalisation, the Indian equity market is considered large relative to the country's stage of economic development. Metropolitan Stock Exchange of India Limited (MSE) is recognised by the Securities and Exchange Board of India (SEBI) under Section 4 of Securities Contracts (Regulation) Act, 1956. The Exchange was notified as a "Recognised Stock Exchange" under Section 2(39) of the Companies Act, 1956 by Ministry of Corporate Affairs, Govt. of India, on December 21, 2012. MSE offers an electronic, transparent and hi-tech platform for trading in Capital Market, Futures and Options, Currency Derivatives and Debt Market segments. The Exchange has also received in-principle approval from SEBI for operationalising SME trading platform. MSE commenced operations in the Currency Derivatives (CD) Segment on October 7, 2008, under the regulatory framework of SEBI and Reserve Bank of India (RBI). MSE launched Capital Market Segment, Futures and Options Segment and flagship index 'SX40' on February 9, 2013, and commenced trading from February 11, 2013. Trading in the 'SX40' index derivatives began from May 15, 2013. 'SX40', is a free-float based index consisting of 40 large-caps, liquid stocks representing diverse sectors of the economy. The Debt Market Segment of MSE was launched on June 7, 2013, and trading commenced from June 10, 2013. The Exchange started live trading in cash-settled Interest Rate Futures (IRF), on Government of India security, in its Currency Derivative Segment from January 20, 2014.

On 9th Jan 2017, the Hon'ble Prime Minister of India, Shri Narendra Modi inaugurated India International Exchange Ltd. (IFSC), India's first international exchange. BSE is the first stock exchange in India to receive approval from SEBI on 26th September 2011 to launch Small and Medium Enterprises (SME) platform. The Platform facilitates capital raising by small and medium enterprises including start-up companies which are in their early stages of growth. It also provides easier entry and exit options for informed investors like angel investors, Venture Capital funds (VCFs) and Private Equities (PEs) etc. and equity financing which lowers the debt burden leading to lower financing cost and healthier balance sheet. SME IPO Index with a Base value of 100 as on 16th August 2012 is aimed at tracking the companies listed on the SME platform was launched on 14th December 2012. As on 31st August 2020, its value was 1,435.44.

BSE is the first stock exchange in India to launch startups platform on 22nd September 2018. The 'Startup Companies' seeking to be listed on the BSE Startups Platform should be in the sector of IT, ITES, Biotechnology and Life Science, 3D Printing, Space Technology, E-commerce, Hi-tech Defence, Drones, Nano Technologies, Artificial Intelligence, Big Data, Augmented/Virtual Reality, Egaming, Exoskeleton, Robotics, Holographic Technology, Genetic Engineering, Variable Computers Inside Body Computer Technology and other high-tech industries.

However, the Indian stock market is dominated by Bombay Stock Exchange and (BSE) and National Stock Exchange (NSE) which are occupying the 11th and 12th largest exchange in the World with the market capitalisation of 1.83 trillion and 1.41 trillion dollars respectively as of 2019. The average listed companies in Indian stock exchanges during the period from 1983 to 2018 was 4370 companies with a minimum of 1151 companies in 1983 and a maximum of 5999 companies in 1996. The latest number of companies in 2018 is 5065 companies. For comparison, the World average in 2018 based on 70 countries is 597 companies. A higher number of listed companies in Indian stock exchanges means that more companies use equity financing in their business. In February 2020, all the securities markets in the World is nosediving coupled with a precipitous fall in crude oil prices. India's market capitalisation to GDP ratio is 81 per cent compared to 51 per cent in Germany (Bloomberg). The market capitalisation of both BSE and NSE decreased by 6.2 per cent as on February 29, 2020, in comparison to previous month post to the first detection of COVID-19 patient in India on 30th Jan 2020 in the State of Kerala.

A snapshot of the growth rates, stock returns, volatility of stock prices, and FII net flows by comparing the major three events such as demonetisation, implementation of GST and the impact of COVID-19 is presented in Table 10.2. The demonetisation phase is considered from 9th November 2016 to 30th June 2017 and from 1st July 2017 to 29th January 2020 as treated as a post-GST phase. Similarly, the period starting from 30th January 2020 to 20 April 2020 are included in COVID-19 phase.

The growth rate of S&P BSE Sensex stock price shows a negative growth (–22.65 per cent) during COVID-19 pandemic phase as compared to positive growth rates of 12.07 per cent and 31.9 per cent during post demonetisation and GST phases, respectively. However, the other stock indices such as mid-cap, small-cap and all sectors except health care show drastic negative growth rates during COVID-19 phase as compared to demonetisation and GST phases. Both the returns and volatility series of stock indices reveal a precarious scenario during COVID-19 phase in comparison to other events.

All the stock indices except healthcare show negative returns and high volatility during this ongoing COVID-19 pandemic. Among three major stock indices as reported in Table 10.1, the growth and return of small-cap companies are a worse performer as compared to mid-cap and BSE Sensex, whereas, the BSE Sensex stock price is more volatile as compared to mid-cap and small-cap stock indices. Nevertheless amongst the sectors, realty, metal, Bankex and auto are a worse

Table 10.2: Trends of Growth, Stock Returns and Volatility of Stock Prices, and FII flows during the phase of Post Demonetisation, Post GST and COVID-19 pandemic

Variables	COVID-19 Pandemic				Post Demonetisation			Post GST		
	Growth	Return	Volatility	Correlation	Growth	Return	Volatility	Growth	Return	Volatility
Stock Indices										
SENSEX	-22.65	-0.54	2.77	0.15	12.07	0.08	0.51	31.96	0.05	0.59
Mid-cap	-24.15	-0.59	2.13	0.22	12.99	0.08	0.67	6.38	0.01	0.72
Small-cap	-25.96	-0.63	1.99	0.27	18.07	0.11	0.70	-4.70	-0.01	0.70
BSE100	-22.78	-0.55	2.65	0.16	12.01	0.08	0.55	23.29	0.04	0.60
BSE200	-22.76	-0.55	2.58	0.16	12.34	0.08	0.55	22.14	0.03	0.60
BSE500	-23.24	-0.56	2.53	0.17	13.16	0.08	0.55	19.36	0.03	0.60
Sectorial Indices										
Auto	-30.95	-0.77	2.69	0.21	5.18	0.04	0.81	-22.16	-0.04	0.90
Bankex	-33.17	-0.84	3.29	0.16	17.66	0.11	0.77	33.87	0.05	0.82
Cap-Goods	-30.12	-0.74	2.43	0.24	19.04	0.11	0.74	2.82	0.01	0.85
Con-dura	-21.22	-0.49	2.25	0.11	28.33	0.16	0.91	60.88	0.08	0.84
FMCG	-7.76	-0.20	2.25	0.06	21.40	0.12	0.74	10.33	0.02	0.65
Healthcare	5.76	0.09	1.96	0.17	-6.93	-0.05	0.74	0.45	0.00	0.78
IT	-19.16	-0.46	2.45	0.13	-0.15	0.00	0.83	63.96	0.08	0.81
Metal	-34.63	-0.90	3.27	0.16	8.40	0.05	1.16	-14.95	-0.02	1.27
Oil and Gas	-20.67	-0.51	2.62	0.18	10.91	0.07	0.76	9.57	0.02	0.93
Power	-21.47	-0.50	2.18	0.26	11.92	0.07	0.74	-12.93	-0.02	0.77
PSU	-28.13	-0.70	2.58	0.21	5.11	0.03	0.74	-17.41	-0.03	0.92
Realty	-41.76	-1.11	2.73	0.23	38.45	0.21	1.45	21.17	0.03	1.22
TECK	-17.87	-0.42	2.40	0.12	1.94	0.01	0.74	44.66	0.06	0.73
FII Flows										
Aggregate Flows										
Purchases	9.0	-	49.46	-0.10	11.99	-	61.47	10.6	-	57.34
Sales	7.9	-	45.10	-0.16	9.27	-	49.80	9.7	-	65.92
Net	-21.3	-	492.96	0.10	-27.20	-	1081.92	-163.8	-	5394.32
Equity						-				
Purchases	13.6	-	63.15	0.07	12.16	-	61.47	12.2	-	63.78
Sales	8.0	-	47.09	-0.05	9.38	-	50.97	9.5	-	58.88
Net	-69.9	-	1997.07	0.13	-587.07	-	8503.84	171.1	-	6845.09
Debt										
Purchases	65.9	-	209.65	-0.27	86.15	-	408.56	-	-	-
Sales	39.9	-	142.78	-0.26	65.16	-	303.68	313.7	-	6197.72
Net	42.7	-	807.85	0.07	1252.35	-	15856.43	148.2	-	5943.26

Source: Mishra, Rath and Dash (2020)

performer in terms of stock returns as well as the growth of the stock price. Since the demand for healthcare products and services are important during this COVID-19 pandemic, which could perhaps reflect in showing a positive stock price returns with low volatility. The second-best performer during this ongoing pandemic is Fast-Moving Consumer Goods (FMCG) companies, which also show a relatively less affected sector as compared to other sectors. The net FII flows figures demonstrate a negative growth during all three phases, but this indicator is less volatile in COVID-19 phase as compared to the other two events. This implies that although the average gross sales are higher than average gross purchase, growth of FII outflows from Indian financial market is still lower in COVID-19 phase as compared to post demonetisation and post-implementation of GST phases (Mishra, Rath and Dash, 2020).

Check Your Progress 2

- 1) Why is a developed stock market considered as a barometer of economic growth?

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- 2) What is market capitalisation ratio?

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- 3) Explain the structure of Indian Stock Market. What are the various reforms brought through these years in this market?

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- 4) How has the Indian Stock market been performing during the times of GST implementation and demonetisation?

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10.5 EQUITY DERIVATIVES IN INDIA

A derivative security is a financial contract whose value is derived from the value of something else, such as a stock price, a commodity price, an exchange rate, an interest rate, or even an index of prices. Derivatives may be traded for a variety of reasons. A derivative enables a trader to hedge some pre-existing risk by taking positions in derivatives markets that offset potential losses in the underlying or spot market. In India, most derivatives users describe themselves as hedgers (Fitch Ratings, 2004) and Indian laws generally require that derivatives be used for hedging purposes only. Another motive for derivatives trading is speculation (i.e. taking positions to profit from anticipated price movements). In practice, it may be difficult to distinguish whether a particular trade was for hedging or speculation, and active markets require the participation of both hedgers and speculators. The third type of trader, called arbitrageurs, profit from discrepancies in the relationship of spot and derivatives prices, and thereby help to keep markets efficient. Equity derivatives trading started in India in June 2000, after a regulatory process which stretched over more than four years. In July 2001, the equity spot market moved to rolling settlement. India's experience with the launch of the equity derivatives market has been extremely positive, by world standards. NSE is now one of the prominent exchanges amongst all emerging markets, in terms of equity derivatives turnover. There is an increasing sense that the derivatives market is playing a major role in shaping price discovery.

10.5.1 Exchange-Traded and Over-the-Counter Derivative Instruments

OTC (over-the-counter) contracts, such as forwards and swaps, are bilaterally negotiated between two parties. The terms of an OTC contract are flexible and are often customised to fit the specific requirements of the user. OTC contracts have substantial credit risk, which is the risk of the counterparty that owes money defaults on the payment. In India, OTC derivatives are generally prohibited with some exceptions: those that are specifically allowed by the Reserve Bank of India (RBI) or, in the case of commodities (which are regulated by the Forward Markets Commission), those that trade informally in "hawala" or forwards markets. An exchange-traded contract, such as a futures contract, has a

standardised format that specifies the underlying asset to be delivered, the size of the contract, and the logistics of delivery. They trade on organised exchanges with prices determined by the interaction of many buyers and sellers. In India, two exchanges offer derivatives trading: the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). A snapshot of turnover in BSE is presented in Table 10.3. However, NSE now accounts for virtually all exchange-traded derivatives in India, accounting for more than 99 per cent of volume in 2003-2004. Contract performance is guaranteed by a clearinghouse, which is a wholly-owned subsidiary of the NSE. Margin requirements and daily marking-to-market of futures positions substantially reduce the credit risk of exchange-traded contracts, relative to OTC contracts (Asani Sarkar, 2006).

In the exchange-traded market, the biggest success story has been derivatives on equity products. Index futures were introduced on June 12, 2000, followed by index options on June 4, 2001, and options and futures on individual securities in July 2001 and November 2001, respectively. As of 2005, the NSE trades futures and options on 118 individual stocks and 3 stock indices. The NSE currently provides trading in futures and options contracts on indices such as Nifty 50 index, Nifty IT index, Nifty Bank index, Nifty Midcap 50 index, Nifty Infrastructure index, Nifty PSE index, and Nifty CPSE. All these derivative contracts are settled by cash payment and do not involve physical delivery of the underlying product. Derivatives on stock indexes and individual stocks have grown rapidly since inception. In particular, single stock futures have become hugely popular, accounting for about half of NSE's traded value in October 2005. NSE has the highest volume (i.e. the number of contracts traded) in the single stock futures globally, enabling it to rank 16 among world exchanges in the first half of 2005. Single stock options are less popular than futures. Index futures are increasingly popular and accounted for close to 40 per cent of traded value in October 2005. NSE launched interest rate futures in June 2003 but, in contrast to equity derivatives, there has been little trading in them. One problem with these instruments was faulty contract specifications, resulting in the underlying interest rate deviating erratically from the reference rate used by market participants. Institutional investors have preferred to trade in the OTC markets, where instruments such as interest rate swaps and forward rate agreements are thriving. As interest rates in India have fallen, companies have swapped their fixed rate borrowings into floating rates to reduce funding costs. However, it may be noted that the detailed discussion of Equity Derivative instruments is beyond the scope of this unit. Table 10.4 presents the turnover of stock options in both BSE and NSE in panel A and B respectively. The NSE witnessed a domestic market share of 84 per cent in the cash market segment with 100 per cent market share in the equity derivatives segment during fiscal 2017 (Annual Report of NSE, 2017).

Table10.3: Turnover (BSE) in Indian Equity Derivatives Market

Period	No. of Trading Days	Index Future Turnover (₹ crore)	Stock Future Turnover (₹ crore)	Index Option	
				Call	Put
				Notional Turnover (₹ crore)	Notional Turnover (₹ crore)
2010-11	254	154.08	0.00	0.00	0.25
2011-12	249	178,448.82	10,215.70	200,089.59	418,252.79
2012-13	249	122,373.70	3,418.27	3,230,231.91	3,797,249.17
2013-14	251	63,493.81	54,609.21	5,705,316.57	3,349,884.08
2014-15	243	48,632.28	9,794.23	10,112,605.17	10,016,621.27
2015-16	247	13,097.14	1,349.66	2,560,540.64	1,825,708.15
2016-17	248	2,266.96	203.07	1,254.89	3,214.45
2017-18	246	3,217.54	36.73	5.92	2.28
2018-19	248	39.16	17.78	1,308.50	884.63
2019-20*	183	8,362.57	150.63	13,190.06	6,432.51

Source: BSE and SEBI

Note: * indicates upto 31st Dec 2019, Turnover in notional value.**Table 10. 4: Turnover in Indian Equity Derivatives Market (BSE & NSE)**

Period	Panel-A Stock Options (BSE)						Total	
	Call			Put			No. of Contracts	Notional Turnover (₹ crore)
	No. of Contracts	Premium Turnover (₹ crore)	Notional Turnover (₹ crore)	No. of Contracts	Premium Turnover (₹ crore)	Notional Turnover (₹ crore)		
2010-11	0	0.00	0.00	0	0.00	0.00	5,623	154.33
2011-12	39,848	0.00	1,277.28	7,657	0.00	191.82	3,22,22,825	808,476.00
2012-13	1,78,313	0.00	5,185.77	2,09,557	0.00	5,059.86	26,24,43,366	7,163,518.70
2013-14	6,67,365	0.00	22,185.51	8,77,355	0.00	23,945.21	30,19,42,441	9,219,434.44
2014-15	30,10,092	0.00	93,854.42	27,00,450	0.00	81,233.89	50,54,78,869	20,362,741.27
2015-16	10,09,439	374.25	31,904.12	14,13,452	351.32	42,408.54	10,62,09,394	4,475,008.26
2016-17	0	0.00	0.00	0	0.00	0.00	1,23,538	6,939.37
2017-18	3	0.00	0.18	0	0.00	0.00	44,701	3,262.65
2018-19	2	0.00	0.08	0	0.00	0.00	31,167	2,250.14
2019-20*	8,472	8.96	626.03	7,876	7.58	583.24	2,90,395	29,345.04

Panel-B

	Period Stock Options (NSE)						Total	
	Call			Put			No. of Contracts	Notional Turnover (₹ crore)
	No. of Contracts	Notional Turnover (₹ crore)	Notional Turnover (₹ crore)	No. of Contracts	Premium Turnover (₹ crore)	Notional Turnover (₹ crore)		
2010-11	2,42,73,560	15,710	7,77,109	82,34,833	4,765	2,53,235	103,42,12,062	2,92,48,221
2011-12	2,45,65,283	13,331	6,71,770	1,19,29,088	6,282	3,05,261	120,50,45,464	3,13,49,732
2012-13	4,24,99,219	22,583	13,02,779	2,42,78,974	11,705	6,97,648	113,14,67,418	3,15,33,004
2013-14	5,03,00,025	29,812	15,43,895	2,98,74,406	16,617	8,65,594	128,44,24,321	3,82,11,408
2014-15	6,12,04,473	43,345	22,43,382	3,02,74,736	18,387	10,39,170	183,70,41,131	5,56,06,453
2015-16	6,53,22,962	39,014	23,25,030	3,49,76,212	22,380	11,63,144	209,86,10,395	6,48,25,834
2016-17	6,12,05,774	65,782	41,47,488	3,09,00,238	29,788	19,59,998	139,97,46,129	9,43,70,302
2017-18	8,62,82,094	1,02,165	67,28,007	4,01,29,282	46,053	29,27,002	191,38,78,548	16,49,84,859
2018-19	12,35,10,308	1,28,529	85,17,920	6,34,76,234	71,481	40,64,454	316,48,02,420	23,76,00,705
2019-20*	9,44,82,765	96,372	58,15,639	5,46,53,714	61,374	31,37,545	367,40,28,197	24,64,27,009

Source: BSE, NSE and SEBI

Note: * indicates upto 31st Dec 2019, Turnover in notional value.

Table 10.5: Turnovers in Index Derivatives

Period	(Per cent)					
	BSE		NSE		MSEI**	
	Index Futures	Index Options	Index Futures	Index Options	Index Future	Index Option
2010-2011	100.00	-	19.17	80.83	NA	NA
2011-2012	22.38	77.62	13.61	86.39	NA	NA
2012-2013	1.76	98.24	9.99	90.01	NA	NA
2013-2014	0.75	99.25	10.00	90.00	45.13	54.87
2014-2015	0.24	99.76	9.33	90.67	100.00	-
2015-2016	0.30	99.70	8.52	91.48	-	-
2016-2017	33.65	66.35	5.62	94.38	-	-
2017-2018	99.75	0.25	3.44	96.56	-	-
2018-2019	1.75	98.25	2.67	97.33	-	-
2019-2020*	85.77	14.23	2.06	97.94	-	-

Source: BSE, NSE, MSEI and SEBI

Note: * indicates upto 31st Dec 2019, ** Trading in equity derivatives segment for Index future and option has commenced from May 15, 2013

Table 10.5 reports the turnovers in index futures and index options in three stock exchange such as Bombay Stock Exchange (BSE), National Stock Exchange (NSE), Metropolitan Stock Exchange of India Limited (MSEI). The turnover per cent in both BSE and NSE for the index futures are affected in the year of

2016, 2017 and 2019. This may be due to the impact of demonetisation, implementation of GST and the Global pandemic impact of COVID-19 respectively. However, there is not much impact noticed in the case of index options during the same period.

10.6 CURRENCY DERIVATIVE MARKET IN INDIA

Currency derivative is a contract between the seller and buyer, whose value is to be derived from the underlying asset, the currency amount. A derivative based on currency exchange rates is a future contract which stipulates the rate at which a given currency can be exchanged for another currency as at a future date. Currency future contracts allow investors to hedge against foreign exchange risk. Currency Derivatives are available on four currency pairs viz. US Dollars (USD), Euro (EUR), Great Britain Pound (GBP) and Japanese Yen (JPY). Cross Currency Futures and Options contracts on EUR-USD, GBP-USD and USD-JPY are also available for trading in Currency Derivatives segment (NSE).

Foreign exchange derivatives are less active than interest rate derivatives in India, even though they have been around for longer. Over-the-counter (OTC) instruments in currency forwards and swaps are the most popular. Importers, exporters and banks use the rupee forward market to hedge their foreign currency exposure. Turnover and liquidity in this market have been increasing, although trading is mainly in shorter maturity contracts of one year or less (Gambhir and Goel, 2003). In a currency swap, banks and corporations may swap its rupee-denominated debt into another currency (typically the US dollar or Japanese yen), or vice versa. Trading in OTC currency options is still muted. There are no exchange-traded currency derivatives in India.

10.7 LONG-TERM GOVERNMENT BOND AND CORPORATE DEBT MARKET IN INDIA

The corporate bond and long-term Government Securities market is a vital segment of the capital market. The corporate bond market is at the budding phase in India. The corporate bond market remains restricted for participants, largely arbitrage driven and also highly illiquid. The lack of development is anomalous for two reasons: First, India has developed world-class markets for equities and equity derivatives supported by high-quality infrastructure. Second, the infrastructure for the bond market, particularly the government bond market, is similarly of high quality. Until 2007, information on the Indian corporate bond market turnover was incomplete and largely anecdotal. In 2007, however, the Securities and Exchange Board of India (SEBI) launched initiatives to ensure more comprehensive reporting of the over-the-counter (OTC) bond market. Current volumes are running at low levels— around 140 transactions amounting to about USD80 million per day. But corporate bond markets worldwide are typically illiquid, so it may be overly optimistic to expect India to develop a uniquely liquid corporate bond market. Nonetheless, a more liquid market should eventually contribute to lower costs of capital for issuers. India's corporate turnover ratio is quite high at 70 per cent in 2007, comparing favourably with most other emerging East Asian corporate bond markets. However, the small total of outstanding corporate bonds in India means that the secondary market is small and relatively illiquid, irrespective of the turnover ratio (ADB Working Paper Series No. 22).

10.7.1 Outlook for Development of Corporate Debt Market

The development of a corporate bond market in India has lagged in comparison with other financial market segments owing to many structural factors. While primary issuances have been significant, most of these were accounted for by public sector financial institutions and were issued on a private placement basis to institutional investors. The secondary market, therefore, has not developed commensurately and market liquidity has been an issue.

The Government had constituted a High-Level Committee on Corporate Bonds and Securitisation (Patil Committee) to identify the factors inhibiting the development of an active corporate debt market in India and recommend necessary policy actions. The Committee made several recommendations relating to rationalising the primary issuance procedure, facilitating exchange trading, increasing the disclosure and transparency standards and strengthening the clearing and settlement mechanism in the secondary market. The recommendations have been accepted in principle by the Government, RBI and SEBI and are under various stages of implementation.

The two stock exchanges, namely, the Bombay Stock Exchange (BSE) and the National Stock exchange (NSE), as well as the industry body Fixed Income, Money Market and Derivatives Association of India (FIMMDA) have since operationalised respective trade reporting platforms. While all the exchange trades in corporate bonds get captured by concerned exchange's reporting platform, OTC transactions can be reported on any of these platforms. The aggregated trade information across the platforms is being disseminated by FIMMDA on its website. BSE and NSE have also started order-driven trading platforms in July 2007. In practice, however, trading continues to be largely OTC. SEBI has also implemented measures to streamline the activity in corporate bond markets by reducing the shut period in line with that of G-sec, reducing the size of standard lots to Rs. one lakh and standardising the day count convention. Further, to streamline the process of interest and redemption payments, Electronic Clearing Services (ECS), Real-time Gross Settlements (RTGS) or National Electronic Funds Transfer (NEFT) are required to be used by the issuers.

Further progress is anticipated concerning rationalising the primary issuance procedures, which is a critical step for moving away from the predominance of private placements. To reduce the settlement risk and enhance efficiency, the Patil Committee has also proposed setting up of a robust clearing mechanism. The settlement was proposed to be initially on DVP I basis (i.e. trade by trade basis) to address the counterparty settlement risk and gradually migrate to DvP III (net settlement of funds as well as securities) to impart enhanced settlement efficiency. (The delivery versus payment (DVP) modules can be broadly classified into three broad categories viz. DVP I, DVP II and DVP III. Under DVP I, the fund's leg as well as the securities leg are settled simultaneously on a contract-by-contract basis. Under DVP II, while the securities leg is settled on a contract-by-contract basis, the fund's leg is settled for the net amount). Under DVP III, both the funds and the securities legs are settled for the net amounts.)

Patil Committee has recommended two important measures to be initiated by the Government, namely rationalisation of stamp-duty, and the abolition of tax deduction at source, as in the case of government securities. As the corporate debt markets develop and RBI is assured of the availability of efficient price

discovery through significant increases in public issues as well as secondary market trading, and an efficient and safe settlement system, based on DVP III and STP is in place, RBI is committed to permitting market repos in corporate bonds. In the medium term, considering the overall macro-economic situation, the ceiling for foreign investment in both government securities and corporate debt will continue to be calibrated as an instrument of capital account management. In particular, a more liberalised access to foreign investment would be appropriate when, among other things, an efficient and safe settlement system is well entrenched, aggregate consolidated public debt to GDP ratio reaches a reasonable level, say less than 50 per cent, and the corporate debt market acquires depth and liquidity with a significant role for insurance and pension funds in India. In the past, government securities dominated the debt market in India, partly on account of the fiscal dominance and the absence of contractual savings. In the absence of contractual savings only banks tended to deploy their funds in the corporate bond market, mainly through private placement. RBI is hopeful that the recent slow but steady development of insurance sector, mutual funds etc. coupled with the existence of a reliable government securities market and the availability of robust reporting, trading and settlement mechanisms would lead to the rapid development of a vibrant corporate debt market. A framework for the development is already available through the recommendations of the Patil Committee, the implementation of which has already been taken up by the various agencies (Dr. Y. V. Reddy, 2007).

Check Your Progress 3

- 1) State the reasons for trading in the derivatives.

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- 2) Which instruments are traded in the exchange traded markets?

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- 3) What are the various reforms and recommendations made with respect to the Indian corporate debt market?

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10.8 LET US SUM UP

Globalisation and financial liberalisation in India have ushered in a battery of changes in the financial architecture of the economy, as a result of which the resultant gain of the global integration of domestic and foreign financial markets has thrown open new opportunities but at the same time exposed the financial system to significant risks. While the capital market reforms are impressive, there are still areas that present major problems. The long term debt and corporate debt market present the biggest problems. As a result of which, many large Indian companies look to foreign capital markets for longer-term debt and equity. Despite this, the prevailing economic conditions both at domestic and global levels suggests that the Indian stock market will continue to grow even though the USA and European markets have yet to recover from recession effect. The market ecosystem of the corporate debt market in India is yet to evolve in terms of enabling vibrancy and depth. The enactment of the Insolvency and Bankruptcy Code (IBC), 2016, which incorporates relevant resolution frameworks introduced earlier, is expected to strengthen investors' confidence in the corporate bond market. The 2016-17 Union Budget announcement of setting up of Credit Enhancement Fund could leverage the access of the infrastructure companies into the corporate bond market, complemented by the large exposure framework laid down by the Reserve Bank (RBI, 2019).

10.9 TERM-END EXERCISES

- 1) Discuss the role and scope of a well-developed capital market in the growth process of the economy.
- 2) Trace the developmental reforms of the capital market in India and assess the impact of these reforms in the growth of Equity and the foreign exchange market.
- 3) Discuss the current scenario and shortcomings of the corporate debt market in India.
- 4) Discuss the functions of SEBI. What are the significant steps taken by the SEBI to develop the Indian Equity Market?
- 5) Explain the structure, conduct and performance of the Equity Derivatives market in India.
- 6) Explain the structure and performance of the Indian Currency Derivatives market.
- 7) Explain why the Indian Corporate Debt market is the nascent stage. Suggest necessary reforms.

10.10 KEY WORDS

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|---------------------------|---|---|
| Derivatives | : | Derivatives are financial contracts whose value is linked to the value of an underlying asset |
| Equity Derivatives | : | Equity Derivatives are a type of derivative whose value is derived, at least partly, from underlying equity securities including stocks, stock indexes. |

Foreign Institutional Investor (FII)	: A foreign institutional investor (FII) is an investor or investment fund investing in a country outside of the one in which it is registered or headquartered.
Hawala	: An informal, unregulated mode of transaction, that usually occurs so as to smuggle foreign currency to and fro your country.
Hedging	: Hedging is a risk management strategy employed to offset losses in investments by taking an opposite position in a related asset.
Hybrid Securities	: A hybrid security is a single financial security that combines two or more different financial instruments. They generally combine both debt and equity characteristics.
Over-the-counter (OTC)	: Over-the-counter (OTC) is the trading of securities between two counterparties executed outside of formal exchanges and without the supervision of an exchange regulator.
Speculation	: Speculation is the practice of engaging in risky financial transactions in an attempt to profit from short term fluctuations in the market value of a tradable financial instrument.
Stock Market	: A stock market is a marketplace where buyers and sellers meet to trade i.e. buy and sell shares of publicly listed companies.

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10.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Section 10.1
- 2) See Section 10.1
- 3) See Section 10.2

Check Your Progress 2

- 1) See Section 10.3
- 2) See Section 10.3
- 3) See Section 10.4
- 4) See Section 10.4

Check Your Progress 3

- 1) See Section 10.5
- 2) See Sub-section 10.5.1
- 3) See Section 10.7

UNIT 11 FISCAL POLICY AND FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT (FRBM) ACT

Structure

- 11.0 Objectives
- 11.1 Introduction
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 - 11.2.1 Implications of IS-LM Framework for Fiscal Policy
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 - 11.3.1 Objectives of Fiscal policy
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11.0 OBJECTIVES

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

- state the concept and components of fiscal policy;
- examine how changes in government spending and taxation affect equilibrium level of income and interest rate in terms of the IS-LM framework;
- discuss the fiscal policy in India since independence;
- recognise the need to adopt the Fiscal Responsibility and Budgetary Management Act;
- discuss the role of fiscal policy to meet the challenges arisen out of global financial crises 2008; and
- appreciate the genesis of GST, its implementation and trend of GST collection.

11.1 INTRODUCTION

During the aftermath of the Great Depression in 1930s, British economist John Maynard Keynes first argued for the role of government to push the economy out of the slump. His book *The General Theory of Employment, Interest and Money* is the foundation of the Keynesian economics. He argued for the role of fiscal and monetary interventions by the government to influence the aggregate demand. According to Keynes, high unemployment in Britain and the United States was the result of a deficiency in the aggregate demand. At the time of the Great Depression, Keynes favoured fiscal policy measures to stimulate the demand. This started a new school of thought in the discipline of economics, the Keynesian economics.

Much of the debate over economic policy in Great Britain at that time focused on the desirability of government spending on public works as a cure for unemployment, what we would now term an expansionary fiscal policy action. Keynes and others argued that such actions would increase output and employment. Such expenditures would act both directly and indirectly because they would increase the income and hence consumer expenditure of those employed on the public works projects, thus generating secondary employment.

Major tools of Fiscal Policy are:

- a) **Government Spending:** Change in government spending (revenue or capital expenditure) that directly impacts the GDP and is often used as a counter-cyclical measure.
- b) **Taxes:** Change in the taxes such as the changes in direct and indirect taxes can influence the behaviour of agents in the economy and therefore impact the GDP.

In this unit we dwell into understanding the functioning of such policy changes. The unit discusses the theoretical framework for understanding the fiscal policy. For this purpose we shall use the IS-LM framework to examine how changes in government spending and taxation effects equilibrium level of income and interest rate in the economy. Thereafter, we shall discuss India's fiscal policy experience since independence. It is further sub-divided into sections which describe the evolution of fiscal policy until the 1990s, following the major economic reforms of the 1991 till the next step of fiscal discipline and consolidation based on the FRBM Act. Lastly, we shall talk about the new fiscal framework, recent developments in the fiscal policy space including implantation of the GST. The unit ends with the discussion of the 15th Finance Commission and the challenges that the fiscal policy space currently faces.

11.2 THEORETICAL ANALYSIS: IS-LM FRAMEWORK

Let us recall that we have studied IS-LM framework in Unit 2 of the course Macro-economic analysis (MEC-002) in general. In order to examine the impacts of the various tools of fiscal policy on aggregate income, savings and interest, it is desirable to have a re-look at the IS-LM framework.

A central notion in the Keynesian model is that an equilibrium level of output requires that total output be equal to the aggregate demand. In our model, this condition for equilibrium can be expressed as:

$$Y = AD \quad (1)$$

where, Y represents total output (GDP) and AD stands for aggregate demand or desired expenditures on output.

Aggregate demand (AD) consists of three components:

- household consumption (C),
- desired business investment demand (I),
- and the government sector's demand for goods and services (G).

$$\text{Thus, in equilibrium we have } Y = AD = C + I + G \quad (2)$$

The simple form of Equation (2) and of the identities discussed later results from overlooking some complexities in the definitions of GDP and national income. To begin with we are dealing with a 'closed' economy, hence exports and imports do not appear in Equation (2). We later extend the simple model to include the components of exports and imports. We also assume that prices are constant, that is, all the variables are real variables and hence the changes in these variables are also in real terms.

In the Indian context, National Accounts Statistics (NAS) provides the break-up of the GDP components. The GDP (or Y in the model) is calculated as:

$$GDP = PFCE + GFCE + GCF + NX$$

Where, PFCE (C in Equation 2) is private final consumption expenditure by households

GFCE (G in Equation 2) is government final consumption expenditure

GCF (I in Equation 2) is gross capital formation

NX is net exports (exports – imports).

Figure 11.1 shows the share of the major components of the GDP in India since 1990-91. It is clear that the private final consumption expenditure by the household constitutes majority of the GDP. We now look at each of these components in details to understand how changes in fiscal policy influence the GDP.

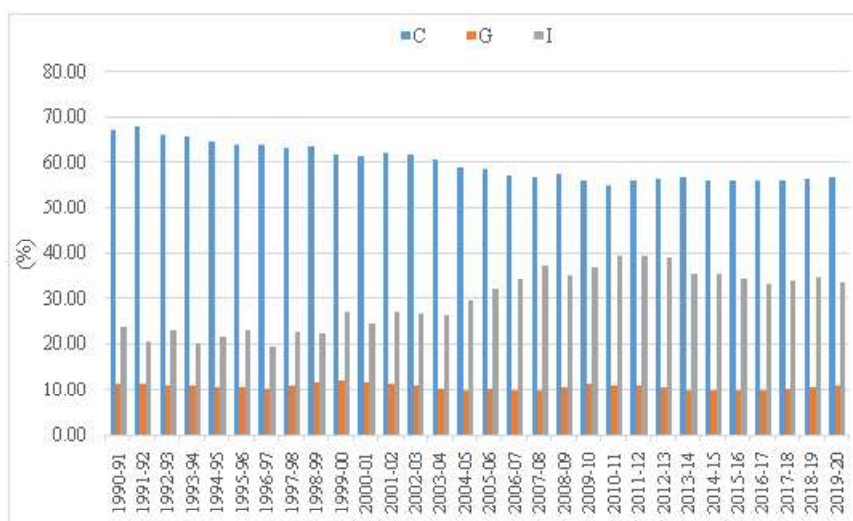


Fig. 11.1: Trends in share of major components of GDP in the overall GDP of India
Source: CMIE

I) Consumption

The private final consumption expenditure (PFCE) by the household constitutes the largest part of the GDP in India, though its share has declined overtime. It formed 56.73 per cent of the total GDP (at constant prices) in 2019-20.

Keynes believed that the level of consumer expenditure is seen as a stable function of disposable income, where disposable income (YD) in our simple model is national income minus net tax payments ($YD = Y - tY$), where t represents the tax rate. The specific form of the consumption-income relationship, termed the consumption function, proposed by Keynes was:

$$C = \bar{C} + c(1-t)Y$$

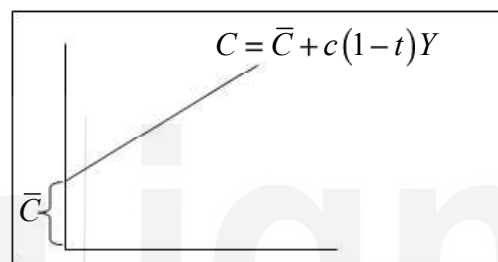


Fig. 11.2: The consumption schedule

The intercept term, which is assumed to be positive, is the value of consumption when disposable income equals zero. As such, it can be thought of as a measure of the effect of variables other than income, i.e. of variables not explicitly included in this simple model on consumption. The parameter c , the slope of the function, gives the increase in consumer expenditure per unit increase in disposable income. In notation, we frequently use

$$c = \Delta C / \Delta Y$$

where, Δ is called delta representing change or difference. It may be recalled that it is the marginal propensity to consume and is a function of several social-cultural and personal factors.

II) Government Spending

Government spending (G) is a second element of aggregate demand. Government spending is assumed to be controlled by the policy maker and therefore does not depend directly on the level of income. It is therefore sometimes represented as $(\bar{G})$ with the bar on top denoting that the variable is constant in the equation. We assume that the level of tax receipts (T) is also controlled by the policy maker and is a policy variable.

III) Investment

Investment is also a key variable in the Keynesian system. Change in the desired business investment expenditure was one of the major factors that Keynes thought was responsible for changes in income. Indeed, investment plays a dual role, it adds to aggregate demand and also to capacity creation, resulting in improved aggregate supply. We take the following function to explain the relationship of investment with the rate of interest (Figure 11.3).

$$I = \bar{I} - bi, b > 0$$

Investment (I) contains an autonomous part and is inversely related to the interest rate (i) as it is the cost of borrowing more capital. b is the responsiveness of investment to the interest rate. Higher b implies that even with a smaller change in interest rate, the investment will change by a greater magnitude. As interest rate goes up, investment in the economy declines by the unit 'b'.

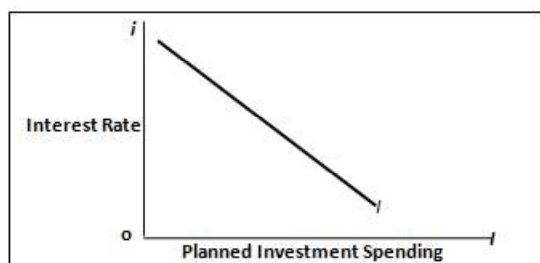


Figure 11.3: The investment schedule

Source: Dornbuschet. al., Macroeconomics, 11thed.

The Goods Market Equilibrium: The IS Curve

Describing the real sector of the economy, the IS curve (Fig. 11.4) represents the condition that aggregate demand (AD) equals national product (Y).

$$AD = C + G + I$$

such that:

$$C = \bar{C} + c(1-t)Y; I = \bar{I} - bi; G = \bar{G}$$

$$AD = \bar{A} + c(1-t)Y - bi$$

where, $\bar{A} = \bar{C} + \bar{I} + \bar{G}$

In equilibrium, $Y = AD$

This implies $Y = AD = \bar{A} + c(1-t)Y - bi$

$$Y - c(1-t)Y = \bar{A} - bi$$

$$Y[1 - c(1-t)] = \bar{A} - bi$$

$$Y = \alpha_g (\bar{A} - bi) \text{ where, } \alpha_g = \frac{1}{[1 - c(1-t)]}$$

$$\text{Or } i = \frac{\bar{A}}{b} - \frac{Y}{\alpha_g b} \quad (3)$$

α_g can be understood as the multiplier. The slope of the IS curve is determined by the value of the multiplier and responsiveness of investment to the interest rate (b).

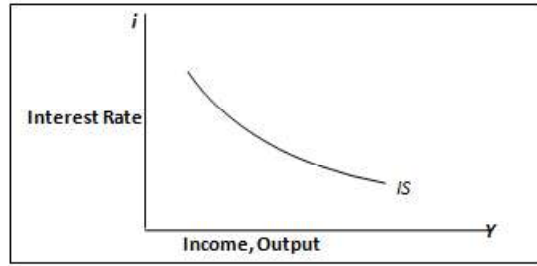


Fig. 11.4: The IS schedule

The Money Market Equilibrium: LM Curve

The demand for real money balance (L) is a positive function of the real income and a negative function of the real interest rate (Figure 11.5). It is given by:

$$L = kY - hi, \text{ such that } k, h > 0$$

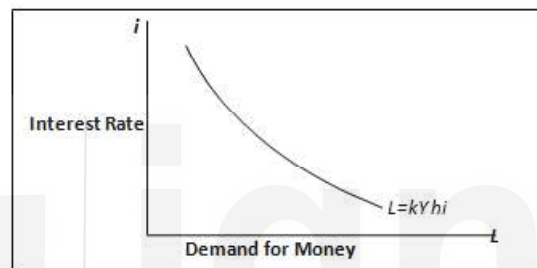


Fig. 11.5: The demand for real balances schedule

Source: Dornbuschet. al., Macroeconomics, 11thed.

The money market equilibrium: Describing the money market of the economy, the LM curve (Figure 11.6) represents the condition that demand for real balances equal real money supply. The nominal stock of money M is determined by the Central Bank, the Reserve Bank of India (RBI) for India. We take the nominal stock of money as given at $\bar{M}$. We also assume prices to be constant at $\bar{P}$, hence the real money supply is $\frac{\bar{M}}{\bar{P}}$. At equilibrium, demand for real balances = supply of real balances, that is,

$$L = \frac{\bar{M}}{\bar{P}}$$

This implies, $kY - hi = \frac{\bar{M}}{\bar{P}}$

$$i = \frac{1}{h} \left[kY - \frac{\bar{M}}{\bar{P}} \right] \quad (4)$$

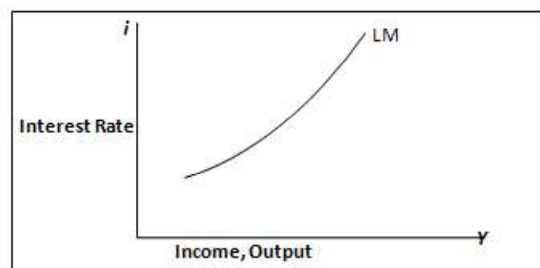


Fig.11.6: The LM Schedule

Source: Dornbuschet. al., Macroeconomics, 11thed.

The equilibrium interest rate in the economy is determined by the interaction of the goods and money market (through Equations 3 and 4). The equilibrium level of income is hence gets simultaneously determined.

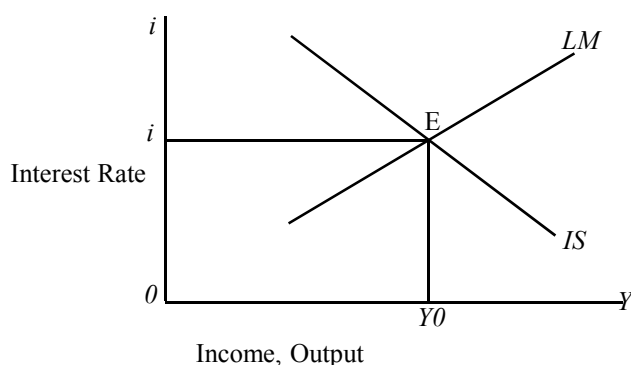


Fig. 11.7: The IS-LM and determination of equilibrium in the economy

Source: Dornbuschet. al., Macroeconomics, 11thed.

11.2.1 Implications of IS-LM Framework for Fiscal Policy

Change in government spending ($\Delta \bar{G}$): If there is an *increase* in the government spending such that the increase in spending is expressed as $\Delta \bar{G}$, this shifts the IS curve outwards to the right. At this stage there is no change in LM curve. The new equilibrium income and interest rate level is determined where the new IS curve intersects the LM curve (E'). The change in the equilibrium level of income will be:

$$\Delta Y = \alpha_g \Delta \bar{G}$$

The new interest rate will be higher than the original interest rate and the change in Y is much more than the initial change in G.

Mechanics: Recalling what has been studied earlier, the increase in autonomous government spending increases the aggregate demand (AD) in the economy shifting IS curve to IS' . This raises the output to Y'' . The increase in income increases the demand for real balances in the economy. Given that the money supply is fixed by the RBI, interest rate has to rise (from i to i') so that money market reaches equilibrium. This increase in interest rate decreases the investment and hence a decline in the overall AD and output also declines to Y' . This decline in private investment as a result of increasing government spending (increase in public investment) is also known as *crowding-out effect* of public investment. Since government spending has to be financed, usually from increased government borrowings, it leaves less of the country's savings to be borrowed by the private sector and that also raises the cost of borrowing for the private sector, leading to crowding-out of private investments. However, evidence from India suggests otherwise, as there exist infrastructural bottlenecks. Hence increasing the public investment actually crowds-in the private investment. Between 1971-71 to 2002-03, there has not been evidence of crowding-out of the private investment due to public investment, rather complementarity is observed between the two¹.

¹Lekha S. Chakraborty; Fiscal Deficit, capital formation and crowding out: Evidence from India.

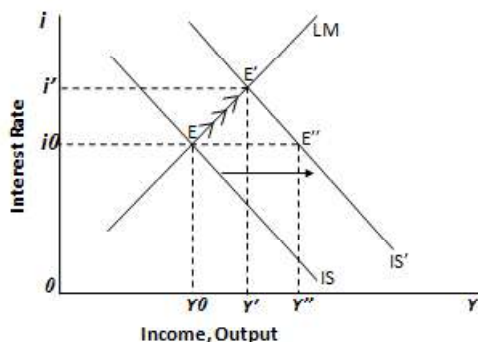


Fig.11.8: Increase in government spending

Source: Dornbuschet. al., Macroeconomics, 11thed.

Increase in government spending is an expansionary fiscal policy. In case of a contractionary fiscal policy measure, the government can reduce the autonomous government spending, shifting the IS curve leftward and reducing the equilibrium level of interest rate and income.

Change in taxes (t): A change in the proportional income tax rate (t) is not as straight forward. Since the change in the income tax affects the disposable income, it changes the consumption. Let us consider an increase in tax rate from t to t' (for e.g., increase in personal income tax from 10 per cent to 20 per cent). This increase in taxes clearly reduces the consumption expenditure by the household as they now have less income at their disposal. A change in the tax rate is going to affect the slope of the IS curve as it changes the multiplier. With taxes being increased to t' (contractionary fiscal policy), the slope of the IS curve will increase and the overall value of the multiplier will decrease. A reduction in the value of multiplier implies that income/GDP will not change as much with the changes in any of its components.

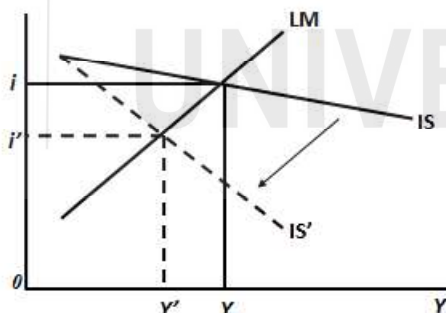


Fig. 11.9: Increase in proportional income tax

Source: Author

Mechanics: As we can see in Figure. 11.9, the slope has increased and the IS has shifted to IS' . There will be no change in LM as there is no change in the money market. With the shift in IS, the new equilibrium income and interest rate is achieved at Y' and i' . As the tax rate has gone up, the disposable income in the hand of consumers decrease. This lowers the consumption demand (C) and decreases the overall aggregate demand (AD). Since the AD decreases the equilibrium income in the economy, the demand for real balances also decrease, but as earlier the supply is fixed. The interest rate reduces as a consequence. This reduction in interest rate increases the investment demand but not by as much to offset the earlier decline in AD .

Check Your Progress 1

- 1) Fill in the blanks.
 - i) In the Indian context, the consumption expenditure incurred by constitutes the majority of GDP.
 - ii) The IS schedule shows the equilibrium.
 - iii) The decline in private investment as a result of increasing government spending is known as
- 2) In terms of the IS-LM framework, explain the mechanics of increasing government spending on a closed economy which is initially in equilibrium.

11.3 CONCEPT OF FISCAL POLICY

We define *fiscal policy* to encompass any decision to change the composition of or timing of government expenditures or to vary the burden, structure, or frequency of tax payment. Governments all around the world use fiscal policy tools as counter cyclical measure i.e., to stabilise economy from cycles of boom and bust.

Fiscal policy aims at using its three major instruments— taxes, spending and borrowing— as balancing factors in the development of the economy. According to Arthor Smithies, fiscal policy is a policy under which government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment. Fiscal policy consists of the use of taxes, government spending and public debt operations to influence the economic activities of the community in desired ways and is concerned with the allocation of resources between the public and private sectors and their use for the attainment of stability and growth. Although the effects of fiscal policy are extensive, they are particularly measurable in areas such as employment, price stability, savings and investment, and the balance of payment. The prime aim of such a policy is to maintain a high level of employment without inflation.

11.3.1 Objectives of Fiscal Policy

Formulation of fiscal policy presumes the identification and clear recognition of the institutional aspects of government finance, such as tax system, tax incidence and shifting, budget formulation and execution and financial management. The focus of budgeting is on the attainment of efficiency in the allocation of resources within the public sector and is influenced at each stage by the goals of the fiscal policy. The changes in government income or expenditure have been designed to affect the level of activity in the economy as a whole. An understanding of the fiscal policy is essential for gaining proper perspectives on the different aspects

of budgeting. In the recent years, importance of fiscal policy has increased due to economic fluctuations.

The budgetary fiscal policy can play a key role in the process of economic development by (i) mobilising additional resources, (ii) maintaining economic stability, (iii) allocating resources into socially necessary lines of development, (iv) reducing extreme inequality in income and wealth, and (v) providing the necessary incentive to the private sector for its healthy growth. The fiscal policy thus has not one goal. It has a multiplicity of goals. Hence, they cannot be achieved by any one set of policies. There may be conflicts between some of these other goals and stabilisation goals. In the context of economic growth, the fiscal policy has to be so framed as to avoid an inflationary pressure in the economy.

11.3.2 Implications of Fiscal Policy

Fiscal policy is so wide-ranging that selection of a combination of differing objectives is both complex and controversial. The decisions that the government makes over fiscal policy can have important implications for business. In today's globalised economy, tax policy is not conducted in a vacuum. Taxes can influence the choices of both business and labour. Supply-side economists argue that economic activity is quite sensitive to changes in tax rates, particularly the highest marginal rates. What causes governments to ignore budget deficits in some circumstances and not in other? Business also needs to understand the effect a change in fiscal policy is likely to have on aggregate demand. In recent decades, the ratio of government expenditure to GDP has increased in most countries. In many countries its present level cannot be financed by ordinary sources of revenue. As a consequence, many governments have been compelled to borrow heavily. If a country borrows too much money, it has to pay a great deal of interest every year in order to service that debt.

The greatest obstacle to proper use of fiscal policy is that changes in fiscal policy may be necessarily bundled with other changes that please or displease various stakeholders. This is true for a tax cut for some favoured constituency. The problem of making good fiscal policy in the face of such obstacles is, in the final analysis, not economic but political. There are many practical limitations or drawbacks to the actual working of the fiscal policy. The objective of fiscal policy in modern society cannot be promoted in isolation. It has to be coordinated with monetary, credit and debt policies to be effective. The questions relating to the manner of financing deficit or disposing of surplus in a budget have close relationship with monetary and credit policies.

Monetary and fiscal policies can be best understood in the context of the events that shape them. Such an analysis can assist in choosing policies that improve rather than disrupt short- and long-term economic performance. Of particularly interest are the circumstances and policies surrounding the recent recession.

11.4 FISCAL POLICY IN INDIA

11.4.1 India's Fiscal Policy Architecture

India adopted a federal form of governance in post-independence period. The Constitution of India (Article 1) states that India, that is Bharat, shall be a Union of States. The Indian Constitution provides the overarching framework for

country's fiscal policy with the assignment of taxation powers and expenditure responsibilities being divided between the Union and State governments. The Seventh Schedule of the Constitution of India specifies the legislative domain of the Union and States Governments in terms of three lists namely, (a) Union List (or List I), (b) State List (or List II), and (c) Concurrent List (or List III). These lists represent the powers conferred upon the Union Government, State Governments, and shared powers between the two respectively. All residuary powers are vested with the Union. The Constitution also provides that for every financial year, the government shall place before the legislature a statement of its proposed taxation and expenditure provisions, also known as the budget, for legislative debate and approval. The Union and the State governments each have their own annual budgets. Details on this aspect has been provided in the next unit (Unit 12).

11.4.2 Fiscal Policy until 1990s

The formation of a Planning Commission, prompted by Prime Minister Nehru's commitment, was announced in the Finance Minister's Budget Speech in February, 1950. The Commission was established on 15th March, 1950 through a cabinet resolution with primary objectives of formulating medium to long term plans, advising on allocation of funds to Ministries in the Union Government through annual budget, approving the plan of each State. The resolution clearly indicated that the Commission would essentially be an advisory body which would make recommendations to the Cabinet. The Planning Commission, by virtue of its mandate to prepare Five-year Plan came to exercise allocative powers. One of the roles that it performed was to approve Plans of each of the states and allocate transfer of funds from the Union government to States, both tied and untied under the Plan.

The main fiscal impact of the planning process is the division of expenditures into plan and non-plan components. The *plan components* relate to items dealing with long-term socio-economic goals as determined by the ongoing planning process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes. *Non-plan* expenditures broadly relate to routine expenditures of the government for administration, salaries, and the like².

The objective of the initial five-year plans during the *1950s and 1960s* was mainly to become a self-sufficient nation and increase the growth rate of the economy through strengthening the public sector enterprises. Taxation was used as an instrument for transferring resources to the Government to enable it to undertake large-scale public investment in an effort to spur economic growth. Both direct and indirect taxes were focussed on extracting revenues from the private sector to fund the public sector. The combined centre and state tax revenue to GDP ratio increased from 6.03 per cent in 1950-51 to 15.47 per cent in 1987-88. For the central government this ratio (i.e., central taxes net of devolution to GDP ratio) was 3.43 per cent of GDP in 1950-51 with the larger share coming from

² The distinction between plan and non-plan government spending has been dispensed with and now the classification of government spending follows the categorisation of revenue and capital spending.

indirect taxes at 2.20 per cent of GDP and direct taxes at 1.23 per cent of GDP. Given their low direct tax base, the direct tax-GDP ratio of state governments was 0.53 per cent while their share of indirect taxes in GDP was 1.61 per cent in 1950-51. Furthermore, the fiscal policy was geared towards achieving the economic objectives of (i) promoting employment through grant of tax incentives to new investment; (ii) reducing inequality through progressive taxes on income and wealth; (iii) reducing pressure on balance of payments through increase of import duties; and (iv) stabilising prices through tax rebate in excise duties on consumption goods³.

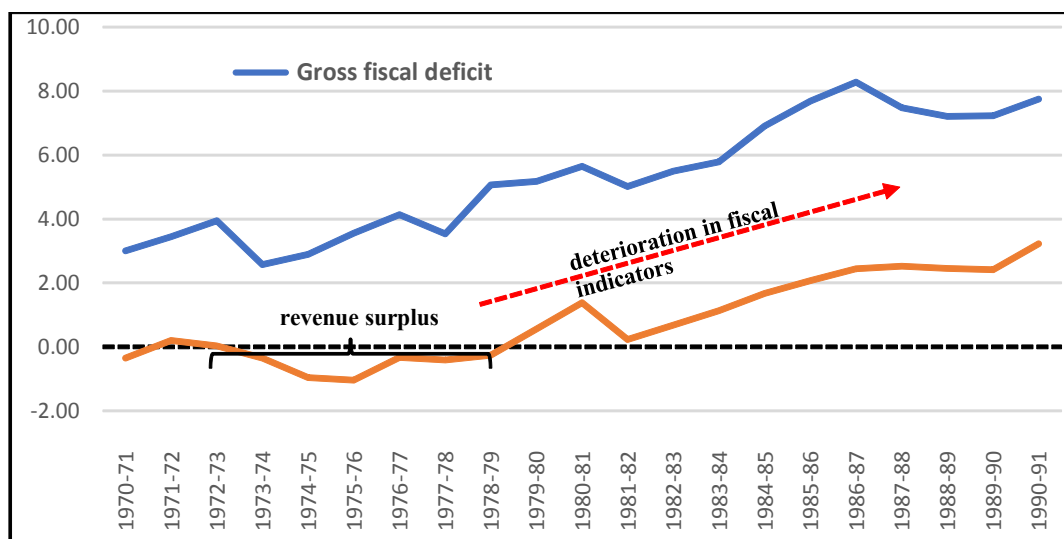
The systemic evolution of tax system in India started with the implementation of a number of recommendations of the Taxation Enquiry Commission in 1955-56 which was appointed in April, 1953. The Commission submitted its report in December, 1954. However, the government invited the British economist Nicholas Kaldor to examine the possibility of reforming the tax system. The findings and recommendations of Kaldor was published in a report in 1956. Kaldor found the system is inefficient and inequitable given the narrow tax base and inadequate reporting of property income and taxation. He also found the maximum marginal income tax rate at 92 per cent to be too high and suggested it be reduced to 45 per cent. In view of his recommendations, the government revived capital gains taxation, brought in a gift tax, a wealth tax and an expenditure tax (which was not continued due to administrative complexities).

Despite Kaldor's recommendations, for both corporate and personal income taxes the highest marginal income tax rates continued to be very high. The Direct Taxes Enquiry Committee of 1971 found that the high tax rates encouraged tax evasion and following its recommendations in 1974-75, the highest marginal rate for personal income tax was brought down to 77 per cent.

Fiscal policy during the 1970s focused on achieving greater equity and social justice and both taxation and expenditure policies were employed towards that end. Accordingly, income tax rates were raised to very high levels, with the maximum marginal rate of personal income tax moving up to 97.5 per cent including the surcharge. India's expenditure norms remained conservative till the 1980s. From 1973-74 to 1978-79 the central government continuously ran revenue surpluses (Figure 11.10). The gross fiscal deficit (GFD) also showed a slow growth with certain episodes of downward movements. Over the years, in addition to the commitment towards a large volume of developmental expenditure, the Government's expenditure widened to include rising subsidies. Large interest payments on growing debt and downward rigidity in prices further contributed to increased expenditure. Revenues, on the other hand, were less buoyant leading to the emergence of sizeable revenue deficits (RD) in the Central government budget from 1979-80 onwards.

During the decade of 1980s, the Indian public finances were in a state of disarray. We find considerable fiscal deterioration took place during the 1980s and it eventually became unsustainable, although the growth rate did rise significantly with the enhancement in public investment in infrastructure. While the revenue deficit (RD) of the central government as percentage of GDP increased from 1.4 per cent in 1980-81 to 2.44 per cent in 1989-90, its gross fiscal deficit (GFD) as percentage of GDP also increased during this period, increasing from 5.71 per cent in 1980-81 to 7.31 per cent in 1989-90.

³ Rao and Rao, 2006

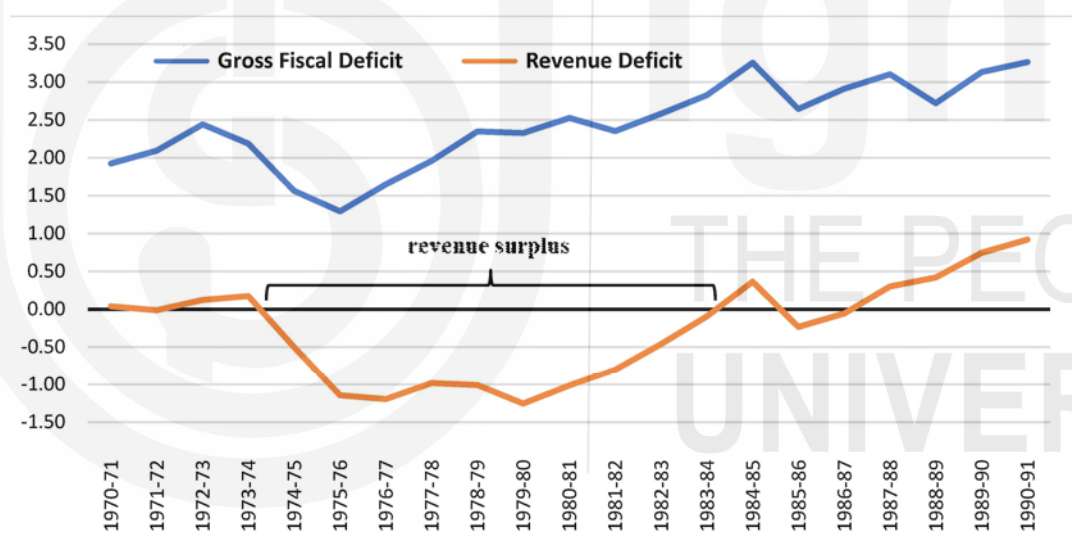


Note: Deficit (+) / Surplus (-)

Fig. 11.10: GFD and RD of the Centre (per cent of GDP)

Source: DBIE and CMIE

The *State governments* had revenue surplus during 1974-75 to 1986-87 with the exception of 1984-85 (Figure.11.11). Their fiscal position also deteriorated in the late 1980s.



Note: Deficit (+) / Surplus (-)

Fig. 11.11: GFD and RD of the States (per cent of GDP)

Source: DBIE and CMIE

Rising deficits and debt reduced the quality of the expenditure with increase in expenditure on interest payment at the cost of social and developmental expenditure. The Government sought to reduce its deficit through increase in taxes. An important reform in the indirect taxes was recommended by the Indirect Tax Enquiry in 1977. It recommended introduction of the input tax credit to convert the cascading manufacturing tax into a manufacturing value added tax (MANVAT). But this was implemented as a modified value added tax (MODVAT) in 1986 in a phased manner covering only selected commodities (Rao and Rao, 2006).

The other main central indirect tax is the customs duty. Customs duties were hiked to augment revenue and to protect domestic industry. In 1985-86 the

government presented its Long-Term Fiscal Policy stressing on the need to reduce tariffs, have fewer rates and eventually remove quantitative limits on imports. Some reforms were attempted but due to revenue raising considerations the tariffs in terms of the weighted average rate increased from 38 per cent in 1980-81 to 87 per cent in 1989-90. By 1990-91 the tariff structure had a range of 0 to 400 per cent with over 10 per cent of imports subjected to tariffs of 120 per cent or more⁴.

The 8th Finance Commission whose operational period was 1984-1989 made it clear that in considering competing claims on resources, the overriding consideration would be national interest. The 8th FC also made the tax devolution more progressive by leaning in favour of the backward states. It also set 5 per cent of the net proceeds of sharable excise duties exclusively for non-plan revenue deficit.

In 1970-71, direct taxes contributed to around 16 per cent of the central government's revenues, indirect taxes about 58 per cent and the remaining 26 per cent came from non-tax revenues. By 1990-91, the share of indirect taxes had increased to 65 per cent, direct taxes shrank to 13 per cent and non-tax revenues were at 22 per cent.

While the institutional arrangements in place initially appeared adequate for driving the development agenda, but the sharp deterioration of the fiscal situation in the 1980s led to the balance of payments crisis of 1991.

11.4.3 Fiscal Policy 1990s Onwards

The political uncertainties both domestic (assassination of Prime Minister Rajiv Gandhi) and abroad (The Gulf War) added to the existing fiscal deterioration of the country. Rising oil prices led to greater burden of the fuel subsidy along with increasing external debt that eventually led to a balance of payment crisis in 1991. The crisis brought about the most important economic reforms which opened up the economy to private players both domestic (dismantling of the License Raj system) and from abroad. Fiscal policy was also re-aligned with these policy changes.

To improve the falling tax receipts and to rationalise the tax structures, Tax Reform Committee was formed with the view to achieve set targets. *The Tax Reforms Committee* (TRC) concentrated on finding a suitable framework to reform both the direct and indirect tax structure in the country. The committee recommended two major reforms on direct taxes— one was the simplification and rationalisation of the direct tax structure (*The Chelliah Committee*, 1992); the other was to introduce a service tax to widen the tax base (*The Chelliah Committee*, 1994).

As a part of the subsequent *direct tax reforms*, the personal income tax brackets were reduced to three with rates of 20, 30 and 40 per cent in 1992-93. Financial assets were removed from the imposition of wealth tax and the maximum rate of wealth tax was reduced to 1 per cent. The Personal income tax rates were reduced again to 10, 20, and 30 per cent in 1997-98. These rates have largely remained the same since then with the exemption limit being increased and slab structure raised from time to time. A subsequent 2 per cent surcharge to fund education was later made applicable to all taxes.

⁴ Rao and Rao, 2006

The basic corporate tax rate was reduced to 50 per cent and the rates for different closely held companies were made uniform at 55 per cent. In 1993-94, the distinction between the closely held and the widely held companies was removed and the uniform tax rate was brought down to 40 per cent. The rate was further reduced to 35 per cent with a 10 per cent tax on distributed dividends in 1997-98. Even after these reforms, some companies continued to take advantage of the exemptions and tax deduction that were there in place for backward places, export promotion and technology development. This led to the phenomenon of “zero-tax companies” whereby imaginative arrangements were used to leverage all these tax incentives with an intent to minimise tax liabilities. To counter this trend, the Minimum Alternative Tax (MAT) was introduced in 1996-97 that required a company to pay a minimum of 30 per cent of book profits as tax.

Under the *indirect taxes*, the MODVAT credit system for excise was expanded to cover most commodities and provide a comprehensive credit system by 1996-97. The eleven rates were merged into three with a few luxury items subject to additional non-rebatable tax in 1999-2000. The three rates were merged in to a single rate and renamed as central VAT (CENVAT) in 2000-01. There remained three additional excises of 8, 16 and 24 per cent. In case of custom duties, in 1991-92 all duties on non-agriculture goods that were above 150 per cent were brought down. The ‘peak rate’ was brought down to 40 per cent in 1997-98, 30 per cent in 2002-03, 25 per cent in 2003-04, and 15 per cent in 2005-06. The number of major duty rates was also brought down from 22 in 1990-91 to 4 in 2003-04. These four rates covered almost 90 per cent of customs collected from items.

This period also saw the introduction of the service tax in 1994-95, which was subsequently expanded to cover more and more services. Given that the Indian economy was having an increasingly large service component, the service tax increasingly became a major source of revenue. Eventually, provisions were made for allowing input tax credits for both goods and services at the central indirect tax level.

In line with the tax reform plans, the share of the direct taxes in the overall revenue receipts started increasing from 1994-95. In 1995-96, about 54 per cent of revenues came from indirect taxes while around 20 per cent were from direct taxes. In 2000-01, the share of indirect taxes had gone down dramatically to around 45 per cent while the contribution from direct taxes had increased to about 26 per cent. By 2005-06, indirect taxes accounted for approximately 43 per cent while the direct taxes share was about 35 per cent (Figure 11.12)

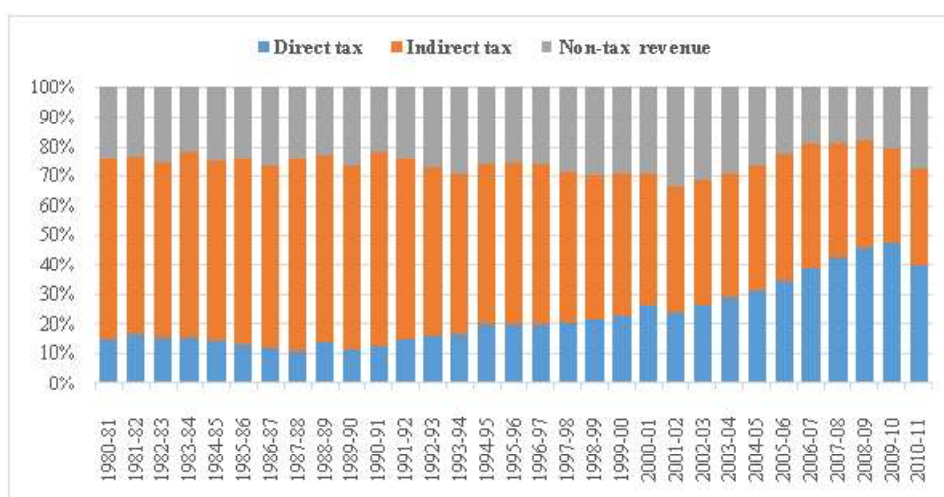


Fig. 11.12: share in the revenue receipts of the Central Govt. (in per cent)

Source: DBIE

On the *expenditure side*, the strategy was to reduce the subsidies and cutting down on non-capital expenditures. However, the existing debt burden meant that the interest component would take a long time to ebb. In 1995-96, of the central government's revenue expenditures, 9 per cent went to subsidies, 13 per cent to defence and 36 per cent to interest payments. Even after the changes in the fiscal policy, the expenditure pattern did not record much change. In 2000-01, defence and interest remained at 13 per cent and 36 per cent, respectively, while subsidies increased slightly to 10 per cent. By 2005-06, the interest component had come down to 30 per cent and defence and subsidies each took up 11 per cent (Figure 11.13).

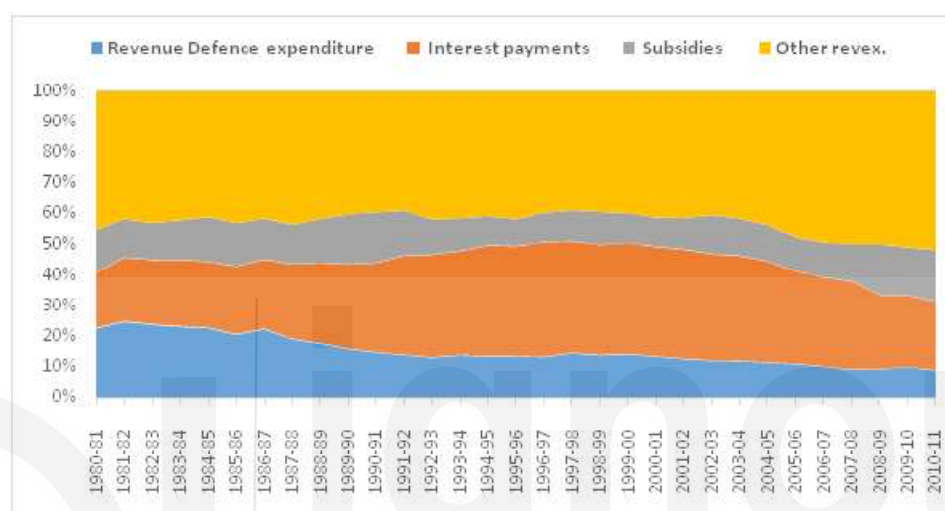


Fig. 11.13: Share in total revenue expenditure of the Central government (in per cent)

Source: DBIE

Even though the fiscal situation of the government improved with the aforementioned measures in the first half of the 1990s, the fiscals started showing signs of distress from 1997-98 with the rising fiscal and revenue deficit. The 11th FC expressed concerns over the feature of fiscal deficit being driven more and more by the revenue account.

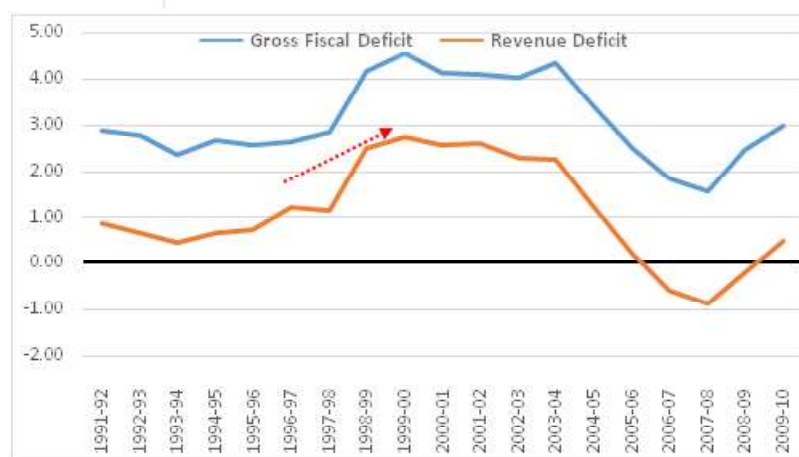


Fig. 11.14: Key fiscal indicators for States as a per cent of GDP

Source: CMIE, DBIE

The situation was grim at the state level as well. The average debt-to-GSDP ratio increased from 18.3 per cent during the 1980s to 20.8 per cent during the 1990s. It further worsened during 1997-2002 and increased by about 6 percentage points

to 26.8 per cent and reaching high of 31.8 per cent in March, 2004⁵. A study by Rajaraman et al. (2005) examined the debt sustainability of all the states in India for a period of 10 years from 1992-93 to 2002-03 using the indicator approach. They found a sharp increase in debt of major states during 1997-02 relative to the average debt level of 1992-97 with the interest rate on the state debt exceeding the nominal growth rate of GSDP during the quinquennial of 1997-02. This necessitated the need for debt consolidation measures and institutional reforms to stabilise debt at both the Centre and the State level. The central government's revenue deficit climbed up to 4.4 per cent of GDP in 2002-03 while the GFD was at 5.91 per cent of GDP. By 2003-04 the combined liabilities of the centre and the States were up at 81.09 per cent of GDP from 70.59 per cent in 2000-01. The external liabilities were however kept under control at only 1.67 per cent of GDP in 2003-04.

There was an urgent need of some new fiscal discipline framework. After around three years of discussions, the Fiscal Responsibility and Budgetary Management (FRBM) Act was adopted in 2003.

Check Your Progress 2

- 1) What are the various fiscal implications of the planning process?

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- 2) What was the focus of fiscal policy during 1970s?

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- 3) What has been the consequence of increasing deficit and debt in 1980s?

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- 4) State the major initiatives taken towards reforms in direct taxes in 1990s.

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⁵ Atri Mukherjee et al. (2017)

11.5 THE FRBM ACT

As alluded to above, periods of macroeconomic instability in India have invariably been pre-dated by fiscal adventurism. In the 1980s, for example, the combined fiscal deficit had widened to 8.6 per cent in 1984-85 and breached 9 per cent of GDP in the ensuing years. Following the crisis, fiscal corrections were pursued along with structural reforms. A combination of these macro policies and other reforms stabilised the economy. However, later in the 1990s, combined fiscal deficits again rose sharply to over 10 per cent. This time the government willingly introduced the *Fiscal Responsibility and Budget Management Bill* in Parliament in the year 2000. The Bill received the assent of the President of India on 26 August 2003 and it became effective from 5 July 2004.

The main objectives of the act were to (a) introduce transparent fiscal management systems in the country; (b) introduce a more equitable and manageable distribution of the country's debts over the years and (c) aim for fiscal stability for India in the long run. The FRBM Act proposed that the central and state fiscal deficit would each be progressively reduced to reach 3 per cent of GDP keeping in mind two considerations – a) consistency with the forecast trend of household financial savings and b) the target being considered sufficient for reducing the stock of outstanding government liabilities to the level of 50 per cent of the GDP within 10 years⁶.

Even though the Constitution enables the adoption of fiscal rules through the prescription of a ceiling on borrowing by the Union and the States, no such legislation was passed. It was only in the FRBM Act, that the limit on the borrowings were imposed indirectly. The FRBM Act, 2003 is a law enacted under Article 292 of the Constitution (read with Article 283) empowering the government to borrow upon the security of the Consolidated Fund of India 'within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed'. Article 293 stipulates restrictions on the power of State governments to borrow.

The Ministry of Finance initiated studies to analyse the international legislative practice in controlling public debt and deficits to suggest a draft 'Public Debt and Guarantee Limitation Act' for India. The draft sought the elimination of the revenue deficit within five years, a steady reduction in the fiscal deficit, capping the growth rate of the stock of liabilities at the growth rate of net tax revenue receipts, the elimination of asset-liability mismatches on a book value basis within 10 years and capping outstanding guarantees to 10 per cent of outstanding liabilities. These provisions not only capped public debt using endogenous budgetary variables (book value of physical and financial assets) but also mandated revenue generation to recoup the progressive use of borrowings for consumption resorted to in the past and the eventual use of borrowed funds for creation of productive assets.

Given the prevailing fiscal stress in the 1990s and the draft of the Public Debt and Guarantee Limitation of India, the Finance Minister constituted a committee on January 17, 2000 under the chairmanship of *Dr. E.A.S. Sarma*, then Secretary, Department of Economic Affairs, Ministry of Finance to study all cognate aspects

and prepare a draft legislation. The Committee submitted its Report on 4 July 2000. It identified three categories of indicators for numerical fiscal targets with specific time frames: (i) revenue and fiscal deficits; (ii) total liabilities/debt; and (iii) borrowing from the RBI. Eight deficit indicators were considered but for simplicity and focused attention, the Committee recommended ceilings for only two – fiscal and revenue deficits. It sought to discourage excessive deficit for accumulating capital assets by mandating a progressive reduction in the fiscal deficit by 0.33 per cent of GDP at the end of each financial year so as to reduce to the fiscal deficit to no more than 3 per cent of GDP in five years ending on 31 March 2006. The Committee also recommended the complete elimination of the revenue deficit in five years ending on 31 March 2006 through annual reductions of 0.5 per cent of GDP, and to build up an adequate revenue surplus thereafter. This would ensure the observance of the ‘golden rule’, i.e., revenue surpluses would be used for the purpose of discharging liabilities in excess of assets. In addition to limits on the deficit, the proposed legislation also limited guarantees to 0.5 per cent of GDP in any given financial year. The committee also advocated a debt-GDP ratio of 50 per cent in a period of 10 years commencing on 1 April 2001⁷.

Karnataka became the first state to enact its FRBM Act in September 2002 followed by Kerala (2003), Tamil Nadu (2003) and Punjab (2004). At the Union govt. level, the Act and the Rules made under the Act were brought into force on 5 July 2004. West Bengal and Sikkim were the last two states to implement the FRBM Act in July and September 2010, respectively.

In July, 2004, a *Task Force led by Dr Vijay L. Kelkar* recommended various measures for implementation of the FRBM Act and substantially, a path of revenue-led fiscal consolidation. The Committee also recommended the introduction of a comprehensive tax on all goods and service replacing Central level VAT and State level VATs. It recommended replacing all indirect taxes except the customs duty with value added tax on all goods and services with complete set off in all stages of making of a product. Other states also implemented the legislation to avail the benefits under the incentive scheme recommended by the 12th Finance Commission (12th FC). Some of the major recommendation of the 12th FC to restructure the public finances include:

- 1) By 2009-10, the combined tax-GDP ratio of the Centre and the States should be increased to 17.6 per cent, primary expenditure to a level of 23 per cent of GDP and capital expenditure to nearly 7 per cent of GDP.
- 2) The combined debt-GDP ratio with external debt measured at historical exchange rates should, at a minimum, be brought down to 75 per cent by the end of 2009-10.
- 3) The system of on-lending should be brought to an end over time and the long-term goal for the Centre and States for the debt-GDP ratio should be 28 per cent each.
- 4) The fiscal deficit to GDP ratio targets for the Centre and the States may be fixed at 3 per cent of GDP each.
- 5) The centre’s interest payment relative to revenue receipts should reach about 28 per cent by 2009-10. In the case of States, the level of interest payments relative to revenue receipts should fall to about 15 per cent by 2009-10.

⁷ NK Singh Committee Report

- 6) The revenue deficit relative to GDP for the Centre and the States, for their combined as well as individual accounts should be brought down to zero by 2008-09.
- 7) *Each State should enact a fiscal responsibility legislation*, which should, at a minimum, provide for
- eliminating revenue deficit by 2008-09;
 - reducing fiscal deficit to 3 per cent of GSDP or its equivalent, defined as the ratio of interest payment to revenue receipts;
 - bringing out annual reduction targets of revenue and fiscal deficits;
 - bringing out annual Statement giving prospects for the State economy and related fiscal strategy; and
 - bringing out special Statements along with the budget giving in detail the number of employees in Government, public sector, and aided institutions and related salaries.

Other measures to expand the tax base and increase revenues were the introduction of the securities transaction tax (STT) in 2004 and the fringe benefit tax (FBT) in the budget of 2005-06 (Rao and Rao, 2006).

The fiscal deficit for the Central government apparently declined from 4.34 per cent in 2003-04 to 2.54 per cent in 2007-08, achieving the target of 3 per cent of GDP one year in advance and the revenue deficit also apparently came down from 3.5 per cent of GDP in 2003-04 to 1.1 per cent of GDP in 2007-08, and closer to the target of nil in 2008-09. Though several studies have attributed this fiscal consolidation in the first phase of the FRBMA to high GDP growth and tax buoyancy. Simone and Topalova (2009) estimate that two-thirds of the fiscal adjustment in this period was due to revenue gains. Study by Dholakia et al. (2011) pointed out that much of the improvement in the financial position of the Central government arose due to revenue buoyancy.



Fig.11.15: Fiscal and revenue deficit for the Centre as a percentage of GDP

Source: DBIE

The basis of these claims lay in unprecedented nominal growth in GDP. The nominal year-on-year growth rate of both direct and indirect central taxes (net of transfers to States) increased consistently from 2001-02 onwards. These dynamics

translated into a considerable rise in the net central tax/GDP ratio, particularly the net central direct tax/GDP ratio, which more than doubled between 2001-02 and 2007-08. Inflation was moderate and growth was buoyant at 9.6 per cent in 2006-07. This benign macroeconomic environment was disturbed by the global financial crisis.

11.6 THE GLOBAL FINANCIAL CRISIS AND FISCAL POLICY

The global financial crisis that erupted around September 2008 saw Indian fiscal policy being tested to its limits. The policymakers had to grapple with the impact of the crisis that was affecting the Indian economy through three channels: (i) contagion risks to the financial sector, (ii) the negative impact on exports and (iii) the effect on exchange rates. One could also add to this list the dampening of domestic business sentiments as a result of the deterioration in the economic prospects in developed countries in the wake of the global financial crisis. Somewhat serendipitously, the government already had an expansionary fiscal stance in view of a rural farm loan waiver scheme, the expansion of social security schemes under the National Rural Employment Guarantee Act (NREGA) and the implementation of revised salaries and pensions for the central public servants as per the recommendations of the Sixth Pay Commission. Furthermore, the parliamentary elections of 2008 also resulted in further increase in government expenditures.

As the crisis unfolded, the government initiated a series of stimulus packages on 7th December 2008, 2nd January 2009 and 24th February 2009. Actions included an overall central excise duty cut of 4 per cent, ramping up additional plan expenditure of about Rs. 200 billion, further state government borrowings for planned expenditure amounting to around Rs. 300 billion, interest subsidies for export finance to support certain export-oriented industries, a further 2 per cent reduction of central excise duties and service tax for export industries (in all a total of 6 per cent central excise reduction). The impact of these measures is estimated to be around 1.8 per cent of GDP in 2008-09. If the increase in public expenditure across the budgets of 2007-08 and 2008-09 is taken together it amounted to over 3 per cent of GDP.

In 2008-09, there was a reversal of the steady fiscal consolidation being pursued. The budgeted fiscal deficit for 2008-09 was 2.5 per cent of GDP, while the revised estimates shown in the interim budget presented in February 2009 was 6 per cent of GDP. However, the Centre's actual fiscal deficit in 2008-09, inclusive of the off-budget expenditures of oil and fertilizer bonds was in fact 7.8 per cent despite significant under-reporting through deferment of expenditure liabilities. Thus, the total deterioration in the fiscal deficit in 2008-09 was a dramatic 5.3 per cent of GDP. The revenue deficit also ballooned considerably in 2008-09, from the budgeted 1 per cent to the revised 4.4 per cent of GDP. Accounting for the off-budget bonds brought the number to an unprecedented 6.3 per cent of GDP (Buiter and Patel, 2010).

Unlike international best practices, neither the escape clause (first proviso to Section 4) of the FRBM Act nor the associated FRBM Rules mandate a clearly defined correction path that would facilitate a return to fiscal consolidation following a breach in adherence to the fiscal rules. The Finance Minister in his

2011-12 Budget Speech announced that amendments would be made to the FRBMA along with “laying down the fiscal map for the next five years.” In the succeeding year’s Budget Speech, the FM yet again announced that amendments to FRBMA would be introduced through the Finance Bill of 2012. The Finance Bill proposed that the new target for the reduction of GFD and RD, and elimination of effective revenue deficit be set as March 31, 2015. These proposals resulted in amendment of FRBMA in May 2013. The term ‘effective revenue deficit’ was also introduced into FRBMA through Finance Bill of 2012. The government then revised the FRBMA further in the Finance Bill of 2015 by amending Section 4 to change deadline of March 31, 2015 to March 31, 2018, to grant the newly formed Government in May 2014, some more fiscal space to achieve deficit targets.

The need for review of the FRBMA is in sync with the need for enhancing credibility, discipline, transparency and accountability in the conduct of macroeconomic policy. The 13th Finance Commission recommended that the Centre should institute a process of independent review and monitoring of the implementation of the FRBMA. Accordingly, the Act was amended in 2012 to provide for the government entrusting a periodical review of compliance with the provisions of the Act to the Comptroller and Auditor-General (CAG).

The NK Singh Committee (FRBM Review Committee): In May 2016, Government of India constituted a five-member committee to review the working and functioning of FRBMA. On January 23, 2017, the committee submitted a report to the Finance Minister. Its main policy recommendations are summarised below:

- 1) Adopt a prudent medium-term ceiling for general government debt of 60 per cent of GDP, to be achieved by the fiscal year 2022-23.
- 2) Within the overall ceiling specified above, adopt a ceiling of 40 per cent for the centre, and the balance 20 per cent for the states.
- 3) Adopt fiscal deficit as the key operational target consistent with achieving the medium-term debt ceiling.
- 4) A path of fiscal deficit with fixed operational targets rather than a range.

Table 11.1: The recommended debt-deficit paths by the FRBM review committee

	Debt-GDP ratio (per cent)	Fiscal Deficit (per cent of GDP)	Revenue Deficit (per cent of GDP)
2016-17	49.4	3.5	2.30
2017-18	47.3	3.0	2.05
2018-19	45.5	3.0	1.80
2019-20	43.7	3.0	1.55
2020-21	42.0	2.8	1.30
2021-22	40.3	2.6	1.05
2022-23	38.7	2.5	0.80

Source: NK Singh Committee Report, 2017

- 5) A path of fiscal deficit to GDP ratio of 3.0 per cent during 2017-18 and 2019-20, 2.8 per cent in 2020-21, 2.6 per cent in 2021-22, and 2.5 per cent in 2022-23.
- 6) Reduce revenue deficit to GDP ratio steadily by roughly 0.25 percentage points each year, to reach 0.8 per cent by 2022-23.
- 7) The Inter-State allocation for State Governments for the achievement of the overall debt and fiscal targets be assigned to the 15th FC through a specific Terms of reference (ToR).

The timeline of FRBM Act and relevant developments are present in the table below:

Table 11.2: Timeline of the FRBMA and relevant developments

Month, Year	Event
Jan, 2000	Sarma Committee on Fiscal Responsibility Legislation constituted by Finance Minister
Dec, 2000	FRBM Bill tabled in Parliament
Aug, 2002	Karnataka FRBM Act enacted by State Government
Aug, 2003	FRBM Act receives assent of President
July, 2004	FRBM Rules were notified by government under FRBMA and were brought into force. Task Force (Chairman: Dr Vijay Kelkar) on implementation of FRBMA set up
March, 2006	Date recommended for revenue deficit elimination and reduction of fiscal deficit to 3 per cent by Sarma Committee
March, 2008	First target date by which revenue deficit had to be eliminated and fiscal deficit reduced to 2 per cent of GDP (set by FRBMA)
Sep, 2008	Lehman Brothers files for bankruptcy, Global Financial Crisis
March, 2009	First target date by which revenue deficit had to be eliminated and fiscal deficit reduced to 3 per cent of GDP (set by FRBM Rules)
July, 2009	FRBM targets suspended and Act put on hold till negative effects of Global Financial Crisis are overcome
Feb, 2011	Revised fiscal road map for 5 succeeding years and amendments to FRBMA
May, 2013	Amendments to FRBM Rules
March, 2015	Fiscal and revenue deficit target set in Budget Speech of 2011-12; Fiscal target date set for elimination of revenue deficit (set by FRBM Rules 2013)
May, 2015	FRBM target of March 31, 2015 revised to March 31, 2018
June, 2015	Amendments to FRBM Act
May, 2016	FRBM Review Committee headed by N.K. Singh constituted
Jan, 2017	FRBM Review Committee submits its Report
March, 2017	Fiscal target date by which gross fiscal deficit to be reduced to 3 per cent of GDP (set by FRBM Rules 2013)
April, 2017	FRBM Review Committee Report released to public
March, 2018	First target date by which revenue deficit has to be reduced to 2 per cent and fiscal deficit to 3 per cent of GDP (set by FRBMA 2015)

Source: Charan Singh et. al.

11.7 GOODS AND SERVICES TAX (GST)

India adopted the value added tax (VAT) both at the Central and State level in 2005 with most states and union territories implementing the VAT. However, both central VAT (i.e., CENVAT) and the State VAT had certain incompleteness. The incompleteness in the CENVAT was that it had not been extended to include chain of value addition in the distributive trade below the stage of production. Similarly, in the State-level VAT, CENVAT load on the goods had not yet been removed and the cascading effect of that part of tax burden had remained unrelieved. Moreover, there were several taxes in the States, such as, Luxury Tax, Entertainment Tax, etc. which were still not been subsumed in the VAT. Also there had not been any integration of VAT on goods with tax on services at the state level in order to remove cascading effect of service tax. CST was another source of distortion in terms of its cascading nature. It was also against one of the basic principles of consumption taxes that tax should accrue to the jurisdiction where consumption takes place. Despite remarkable harmonisation in VAT, the national market was fragmented with too many obstacles in free movement of goods necessitated by procedural requirement under VAT and CST.

Integration of Central VAT and State VAT therefore was nothing but an inevitable consequence of the tax reform process. As a natural corollary of this, any unification of the taxation system required a dual GST, levied and collected both by the Union and the States. Power of taxation is assigned to both the Union and States under Schedule VII of the Constitution. While the Centre is empowered to tax goods up to the production or manufacturing stage, the States have the power to tax goods at distribution stage. The Union can tax services using residuary powers but States could not. Under a unified Goods and Services Tax scheme, both should have power to tax the complete supply chain from production to distribution, and both goods and services. The Constitution (115th Amendment) Bill, 2011, in relation to the introduction of GST, was introduced in the Lok Sabha on 11.03.2011. The Bill was referred to the Standing Committee on Finance on 29.03.2011 which submitted its report on the Bill in August, 2013. However, the Bill was lapsed with the devolution of the 15th Lok Sabha. The Constitution (122nd Amendment) Bill, 2014 was introduced in the 16th Lok Sabha on 19.12.2014. The Constitution Amendment Bill was passed by the Lok Sabha in May, 2015. The Bill with certain amendments was finally passed in the Rajya Sabha and thereafter by Lok Sabha in August, 2016. Further the bill was ratified by required number of States and received assent of the President on 8th September, 2016 and has since been enacted as Constitution (101st Amendment) Act, 2016 w.e.f. 16.09.2016.

The Goods and Services Tax (GST) was rolled out across the country on July 1, 2017. It replaced several existing multiple taxes levied by the central and state governments. The central and states taxes subsumed in GST is shown in Table 11.3.

India adopted the dual GST model because of its unique federal nature. Under this model, tax is levied concurrently by the Centre as well as the States on a common base, i.e. supply of goods or services or both. GST levied by the Centre would be called Central GST (CGST) and that levied by the States would be called State GST (SGST) and that levied by union territories without legislature will be called UGST. For inter-state transactions and imported goods or services,

an Integrated GST (IGST) is levied by the Central Government. GST is a consumption-based tax/destination-based tax, therefore, taxes are paid to the state where the goods or services are consumed not the state in which they were produced.

Goods and services are divided into five different tax slabs for collection of tax—0 per cent, 5 per cent, 12 per cent, 18 per cent and 28 per cent. However, petroleum products, alcoholic drinks, and electricity are not taxed under GST and instead are taxed separately by the individual state governments, as per the previous tax system⁸.

Table 11.3: Central and States Taxes Subsumed under GST

Central Taxes	State Taxes
1. Central Excise duty (CENVAT)	1. State VAT /Sales Tax
2. Service Tax	2. Central Sales Tax
3. Additional Excise Duties	3. Purchase Tax
4. Excise duty (Medicinal & Toiletries Preparation Act)	4. Entertainment Tax (not levied by local bodies)
5. Additional duties of Customs - Countervailing Duty (CVD)- Special Additional Duty (SAD)	5. Luxury Tax
6. Central Surcharges & Cess	6. Entry Tax (All forms)
	7. Taxes on lottery, betting & gambling
	8. State Surcharges & Cess

As provided for in Article 279A of the Constitution, the GST Council (the Council⁹) was notified with effect from 12.09.2016 which is responsible for conducting regular meeting and taking majority of GST related decisions. One half of the total number of Members of the Goods and Services Tax Council shall constitute the quorum at its meetings. Every decision of the Goods and Services Tax Council shall be taken at a meeting, by a majority of not less than three-fourths of the weighted votes of the members present and voting, in accordance with the following principles, namely: – a) the vote of the Central Government shall have a weightage of one-third of the total votes cast, and b) the votes of all the State Governments taken together shall have a weightage of two-thirds of the total votes cast, in that meeting.

Since its implementation there has been a feeling among states that they have ceded more ground to the union government and that their freedom with regard to changing the rates of value-added tax (VAT), their main source of revenue was entirely lost. In order to protect any revenue loss to states on account of switching to GST, the Goods and Services Tax (Compensation to States) Act, 2017 was enacted in 2017. Compensation will be provided to states for a period

⁸ Besides, some goods and services are exempt also. Rate for precious metals and affordable housing are an exception to 'four-tax slab-rule' and the same has been fixed at 3 per cent and 1 per cent respectively. In addition, unworked diamonds, precious stones, etc. attracts a rate of 0.25 per cent. A cess over the peak rate of 28 per cent on certain specified luxury and demerit goods, like tobacco and tobacco products, pan masala, aerated water, motor vehicles is imposed to compensate States for any revenue loss on account of implementation of GST. The list of goods and services in case of which reverse charge would be applicable has also been notified.

⁹ The Council is comprised of the Union Finance Minister (who is the Chairman of the Council), the Minister of State (Revenue) and the State Finance/Taxation Ministers as members.

of five years– July 2017-June 2022. For the purpose of calculating the compensation amount to be paid to states in any financial year, their revenues in 2015-16 from taxes subsumed in GST will be considered as the base year. A growth of 14 per cent over the base subsumed revenue would be guaranteed to the states. If a state's GST revenue fall short of the of the 14 per cent protected revenue, its revenue loss will be compensated up to the level of assured protection.

Table 11.4 shows the trend in GST collections since its implementation from 1 July 2017. The overall Y-o-Y growth in the collection in 2019-20 over 2018-19 was 3.8 per cent.

Table 11.4: Trend in GST collection (Rs. Crore)

Month	2017-18	2018-19	2019-20	Y-o-Y change in 2019-20 (per cent)
April	–	1,03,459.0	1,13,865.0	10.06
May	–	94,016.0	1,00,289.0	6.67
June	–	95,610.0	99,939.0	4.53
July	21,572.0	96,483.0	1,02,083.0	5.80
August	95,633.0	93,960.0	98,202.0	4.51
September	94,064.0	94,442.0	91,916.0	-2.67
October	93,333.0	1,00,710.0	95,380.0	-5.29
November	83,780.0	97,637.0	1,03,492.0	6.00
December	84,314.0	94,726.0	1,03,184.0	8.93
January	89,825.0	1,02,503.0	1,10,828.0	8.12
February	85,962.0	97,247.0	1,05,366.0	8.35
March	92,167.0	1,06,577.0	97,597.0	-8.43
Total	7,40,650.0	11,77,370.0	12,22,141.0	3.80

Source: GST Council

Check Your Progress 3

- 1) State the objectives of FRBM Act, 2003.

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- 2) What was the targeted fiscal deficit to GDP ratio by the 12th Finance Commission?

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- 3) Explain the channels through which the global financial crises affected Indian economy.

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- 4) State the important recommendations of FRBM Review Committee.

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- 5) Which commodities are out of purview of GST?

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11.8 LET US SUM UP

Fiscal Policy refers to the policy under which government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment. For understanding how changes in government spending and taxation effects equilibrium level of income and interest rate in the economy it is desirable to know the IS-LM framework. Hence Section 11.2 throws light on theoretical analysis of the IS-LM framework.

Fiscal Policy during 1970s focussed on achieving greater equity and social justice and both taxation and expenditure were employed towards this direction. During 1980s, the fiscal deterioration took place and eventually became unsustainable. Rising deficits and debt raised the price of serving the debt in terms of mounting interest payments. This in turn reduced the quality of the expenditure at the cost of social and developmental expenditure.

In the post-reforms period the direct tax structure was simplified and rationalised. As a result, the share of indirect tax declined to 45 per cent and share of direct tax increased to 35 per cent by 2005-06.

On the expenditure side, the strategy was focused to reduce the subsidies and cutting down on non-capital expenditure. By 2005-06, the interest component came down to 30 per cent and defence and subsidies each took up 11 per cent.

Despite these measures, the rising trend of fiscal revenue deficits since 1997-1990 reflected signs of distress. By 2003-04, the combined liabilities of the Centre and the States were up at 81.09 per cent of GDP from 70.59 per cent in 2000-01. This necessitated having a new fiscal discipline frame work and consequently the Fiscal Responsibility and Budgetary Management Act, 2003 was adopted in 2004.

The good and services tax which replaced the layers of multiple taxes levied by the Central and State Governments has been introduced across the country since July 1, 2017. Under the dual GST model, the tax is levied concurrently by the Centre as well as the States on a common base i.e. supply of goods or services or both.

11.9 TERM-END EXERCISES

- 1) Explain how IS-LM framework is useful to examine the impact of government spending and taxation on aggregate income, saving and interest rate.
- 2) Elaborate the broad trends in the pattern of public revenue and public expenditure during last 30 years.
- 3) What do you mean by fiscal imbalance? What are the measures of fiscal imbalance? How far FRBMA has been effective to correct fiscal imbalances?
- 4) State the channels through which global financial crises had affected Indian economy. How far the fiscal policy in India been effective to mitigate the ill effects of global financial crises?
- 5) State the salient features of Goods and Services Tax. Do you think it was a right step to raise the State's resources and in bringing transparency in tax compliance?
- 6) What measures will you suggest to improve the working of fiscal policy in India?

11.10 KEY WORDS

Balance of Payments (BOP) : Statement of the country's trade and financial transactions with the rest of the world during the year.

Capital Budget : This consists of capital receipts and payments. It also incorporates transactions in the Public Account.

Capital Receipts : The main items of capital receipts are loans raised by government from public which are called market loans, borrowings by government from Reserve Bank and other parties through sale of treasury bills, loans received from foreign bodies and governments, and recoveries of loans granted by the Union government to state and Union territory and other parties.

Direct Tax : Tax levied by government on the income and wealth received by households and businesses.

Fiscal Deficit	: The difference between revenue receipts plus non-debt capital receipts on one side and total expenditure including loans, net of repayments on the other side.
Fiscal Policy	: An instrument of demand management which seeks to influence the level of economic activity in an economy through the control of taxation and government expenditure.
Indirect Tax	: A tax levied by government on goods and services.
Monetary Policy	: The tool of macro-economic policy which involves the regulation of money supply, credit and interest rates in order to control the level of spending in the economy.
Non-Tax Revenue	: These receipts of government mainly consist of interest and dividend on investments made by government; fees and receipts for other services rendered by government.
Primary Deficit	: The fiscal deficit minus interest payments.
Public Debt	: National debt and other miscellaneous debt for which the government is ultimately responsible. This would include the accumulated debt of nationalised industries and local authorities.
Revenue Budget	: This consists of the revenue receipts of the government (tax revenues and other revenues) and the expenditure met from these revenues.
Tax Revenues	: These comprise proceeds of taxes and other duties levied by the concerned authority.
Tax Avoidance	: Efforts to avoid paying tax by legal means.
Tax Evasion	: Efforts to evade the payment of tax by illegal means.
Tax Base	: The total pool which tax authorities can tap when levying a tax.
Value Added Tax (VAT)	: A general tax applied at each point of exchange of goods or services from primary production to final consumption. It is levied on the difference between the sale price of output and the cost incurred on its production.

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11.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) i) Household
ii) Good market
iii) Crowding-out effect of public investment
- 2) See Sub-Section 11.2.1

Check Your Progress 2

- 1) See Sub-Section 11.3.2
- 2) See Sub-Section 11.4.2
- 3) See Sub-Section 11.4.2
- 4) See Sub-Section 11.4.3

Check Your Progress 3

- 1) See Section 11.5
- 2) 3 per cent of GDP
- 3) See Section 11.6
- 4) See Section 11.6
- 5) See Section 11.7

UNIT 12 MAJOR DEVELOPMENT ON UNION STATE RELATIONS

Structure

- 12.0 Objectives
- 12.1 Meaning of and Rationale for Federal Structure
- 12.2 Pillars of Federal Finance
 - 12.2.1 Assignments
 - 12.2.1.1 Assignment of Public Expenditure
 - 12.2.1.2 Assignment of Revenue Sources
 - 12.2.2 Vertical and Horizontal Imbalances
 - 12.2.3 Correcting the Imbalances – Inter-governmental Transfers
 - 12.2.4 Sub-national Borrowing
- 12.3 Institutions of Federalism in India
 - 12.3.1 Finance Commission
 - 12.3.2 Planning Commission/NITI Aayog
 - 12.3.3 GST Council
- 12.4 The 14th and 15th Finance Commissions
- 12.5 Trends and Issues in Fiscal Federalism in India
 - 12.5.1 Centralisation and Vertical Imbalance
 - 12.5.2 Regional Equity and Horizontal Imbalance
- 12.6 Let Us Sum Up
- 12.7 Term-end Exercises
- 12.8 Key Words
- 12.9 References
- 12.10 Answers or Hints to Check Your Progress Exercises
- Appendix 12.1
- Appendix 12.2

12.0 OBJECTIVES

This unit is concerned with Union-States financial relations. After going through this unit, you should be able to:

- spell out the principles governing fiscal federalism;
- state the provisions enshrined in Indian Constitution relating to division of financial powers between Union and States;
- discuss the role of various elements of the institutional structure underpinning the Union and State relations;
- appreciate the role of Finance Commission as an institution, and the importance of major recommendations of various Finance Commissions over the years;
- critically examine the major recommendations of 14th Finance Commission, the Terms of Reference and the interim Report of the 15th Finance Commission; and
- evaluate the dimension and nature of issues involved in contemporary Centre-State fiscal situation in the country.

12.1 MEANING OF AND RATIONALE FOR FEDERAL STRUCTURE

Federalism refers to a system with more than one level of governance, each with some autonomy and decision-making powers. A political definition would be more rigorous and would require some specific conditions to be fulfilled, but an economist's definition is not so stringent. As long as all levels (two or more) have the authority to take some key decisions regarding revenue raising and spending public resources, basic conditions for fiscal federalism are satisfied, even if political federalism may not exist. When characterised in this fashion, only the degree of fiscal federalism differs among nations— even the formally unitary countries have aspects of it. This is because economic administration requires a minimum level of decentralisation and some delegation of fiscal powers in the interest of efficiency.

The primary reason for the widespread implementation of the principles of federalism, apart from the political aspects, is its suitability for realising the economic benefits of both small and large size in the same administrative structure. The primary economic benefit of large size is a large common market that allows scaled-up production with economies of scale as also specialisation, making production more efficient. The formation of the European Common Market has been cited as a good example of these benefits of larger size. At the same time, smaller jurisdictions also have the benefit of better information availability, less divergence in tastes and preferences, and easier administration in general. A formal statement of such benefits is given by the decentralisation theorem, which essentially states that a decentralised system of governance better caters to local tastes and preferences, and is therefore more efficient than a centralised system¹. These theoretical and *a priori* insights are well-supported in the case of India, as a nation of its size and diversity appears to be well-suited for a federal system.

12.2 PILLARS OF FEDERAL FINANCE

12.2.1 Assignments

Assignments refer to the distribution of powers and responsibilities of the government between the existing tiers. This is generally formalised in the Constitution of the nation, but often history and conventions play a significant role in the determination of the actual practices. In Canada, the Provinces that came together to form the federation preceded the federal government; accordingly, all powers and functions that were not specifically assigned to the federal government remained with the Provinces. In contrast, the Indian States as we see now were carved out from the whole after independence by the National Legislature. The nation preceded the constituent units, and correspondingly, the States were given specific powers and functions by the Constitution. The exclusive domains of the Union and State governments, in the case of India, are specified in their respective lists in the Constitution, along with a Concurrent list that specifies the functions common to the jurisdictions of both the Union and the States. However, the Union's powers prevail over that of the States in case of any conflict with respect to matters in the Concurrent list. This centralisation

¹ See Oates (1972).

bias is further strengthened with all residuary powers remaining with the Union (also called Central) government².

The overall responsibilities of the government can be broadly classified following Musgrave (1959) into three groups— resource allocation, distribution of wealth and income, and stabilisation of the economy. Of these, the first type of interventions that seek to reallocate resources to various economic activities through fiscal tools are usually thought and actually found in practice to be suitable for all levels of government, depending on the exact nature of the intervention. The other two are conceptually better suited to the national level government as regional or local level policy initiatives can be defeated by inter-jurisdictional mobility of citizens or resources. For example, an aggressive redistributive policy of a sub-national jurisdiction can cause out-migration of the rich from that jurisdiction into other less aggressive jurisdictions. This can continue in principle as long as the policy differential exists till all the rich taxpayers have shifted out and there is no one left to redistribute from. Similarly, stabilisation policy adopted by a sub-national jurisdiction can be neutralised by contrary policies adopted by other jurisdictions. In general, when economic policies require uniformity across the nation to be effective in a federal system, it is better administered by the national government. These considerations apply to both sides of the fiscal operations of the government— revenue raising and public expenditures.

12.2.1.1 Assignment of Public Expenditure

The assignment of expenditure responsibilities and of revenue handles are, in principle, governed by different considerations. The expenditure responsibilities are ideally assigned in such a way that the nature of the function maps closely to the size of the jurisdiction. For example, defense is a national public good (i.e., its benefit area covers the entire nation) that maps best at the central level, and hence best assigned to the Union government. In contrast, public lighting is very much a local public good in nature, and hence best allotted to the local government units. Regional level public goods can be assigned to State governments, and if a particular public good does not map well into the pre-defined jurisdictions, even special purpose sub-national special agencies can be created (e.g., school districts in the USA or river valley project authorities in several countries including Sri Lanka).

Apart from the economic efficiency argument of the ‘decentralisation theorem’ relating to greater cognizance of local variations in demand for public services, the correspondence of benefit area with decision-making jurisdiction internalises costs and benefits of public services and avoids distortions and sub-optimal decisions. This is often termed as the *subsidiarity principle*, although strictly speaking, the general principle essentially requires all decision-making at the most decentralised level by default, and these powers and functions moved up to progressively less decentralised levels only when there are clear and substantive reasons for it. However, considerations of scale economies may sometimes

² This has had significant impact on fiscal federalism, not foreseen by the Constitution makers. The best example is that of no mention of the services sector anywhere in the three lists of the Constitution, except a few specific services. This sector grew faster than all other sectors to become the largest one in terms of share in GDP. The centre claimed the right to tax services sector under the residuary powers clause, and this in fact upset the balance of revenue raising powers between the Centre and the states irrevocably, with strong implications for subnational autonomy.

outweigh the subsidiarity principle in functional assignment. Also, the second-generation theory of fiscal federalism (Qian and Weingast, 1997) asserts that the main consideration in determining assignments should be the ability of any level of government to carry out the function most efficiently, irrespective of the nature of the public service one is considering. This contention is the main argument of the modern theory of competitive federalism as well (Breton, 1987).

12.2.1.2 Assignment of Revenue Sources

As far as revenue-raising is concerned, primarily redistributive taxes like the personal income tax are generally assigned to the national level. Modern corporations are large entities with business operations across a nation, and to prevent tax-induced distortions in location and other business decisions causing inefficiencies, corporate taxation is also usually assigned to national governments. Taxes on foreign trade are also assigned to the national government, as uniformity is required across the nation. As per the original scheme of constitutional assignment in most large federal systems including India, indirect or commodity taxes were distributed among different levels. In India, the Union government levied the Union Excise duty on production, the states levied sales tax (later converted to a variant of Value Added Tax or VAT), and the local bodies could levy Octroi duty. All three taxes were actually taxing consumption, which caused a significant extent of tax overlapping, making it difficult to even assess the effect of various taxes on the prices, leave alone the economic impact of this complex system of indirect taxation. Further, competition among states to attract business into their jurisdiction using the incentive of lower tax rates caused revenue losses for all of them. This system badly needed rationalisation, with an additional issue of the increasing share of the services sector in the GDP and the appropriation of its taxation by the Union government using the residuary powers clause of the Constitution. The rationalisation process was a long drawn-out affair, beginning with efforts to lower the degree of tax competition in stages, and culminating in the introduction of a Goods and Services Tax (GST) in 2017, levied jointly by the Union and the state governments. While indirect tax reform based on introduction of some variant of nationwide VAT has been a recurring phenomenon across the globe for the last fifty years, its structure and administration has neither been uniform, nor free from controversy in large federations. Brazil, Canada and India, three large federations, each have different versions of VAT/GST being levied, and in all three nations the extant system faces some criticism.

In contrast to the broad-based taxes like income tax or VAT, there are some revenue sources the base of which are less mobile and are therefore suited for sub-national governments. For example, property tax or road/bridge tolls are ideal for local bodies, and usually assigned to them. In India, Octroi was a major source of revenue for local bodies in some of the states like Maharashtra, but being a checkpoint-based levy hampering smooth flow of traffic and an anachronism in present times, had to be abolished. To be sure, an appropriate substitute for Octroi was not found, and the concerned local bodies had to make do with less productive and less regular source of income in terms of cash flow. Local bodies also raise revenues from several non-tax revenue sources like fees/rental from markets built/provided by them, and charges for water supply.

Middle-level (regional) governments in principle are assigned taxes that do not

require nationwide uniformity, and do not give rise to externalities outside their boundaries, while internalising externalities that may arise if levied by local governments. States in India typically raise most of their revenues from taxes comprising motor vehicle taxes, state excise, stamp duty and registrations fees apart from GST as the major taxes; a few other smaller sources of revenue like land revenue, profession tax, and electricity duty are also allotted to the states by the Constitution. Significant consolidation of several smaller constitutionally allocated state taxes like entertainment tax, passenger and goods tax, entry tax, and luxury tax levied on goods and services took place while introducing the GST, which subsumed all these taxes. This certainly simplified the tax system of the states. However, the introduction of GST with its legislation dominated by the Union, despite granting states access to the services sector as tax base, has reduced both revenue flow and revenue flexibility/autonomy for several states. Important non-tax revenue sources for some of the states include royalty from minerals including onshore petroleum crude extracted, and income from forests (with some regulation of the use of forest resources)³.

12.2.2 Vertical and Horizontal Imbalances

As the principles governing assignment of government expenditures and revenue sources are different, the two sides would be balanced for any level of government only by accident. In general, because of the bias towards decentralisation of functional responsibilities and government expenditures, the latter are incurred at the sub-national level to a greater extent while, the collection of broad-based taxes and those with substantial economies of scale imparts a bias towards greater centralisation of tax collection. Together, these biases imply that the expenditure responsibilities at the sub-national levels are not adequately supported by the revenue assignments. This is termed as *vertical imbalance*, which is present in varying degrees in practically all federations of the world. There is another type of imbalance that relates to the varying ability of different constituent units at the same level (sub-national), to meet their expenditure needs with their own revenues. This is known as the *horizontal imbalance*, the degree of which is often linked to the level of economic development of the concerned unit. For example, Bihar is likely to have a much higher degree of horizontal imbalance compared to Haryana. Expenditure responsibilities of a poor state like Bihar would be higher because of the inability of the majority of its citizens to pay and access private supply of the services they need, while their low incomes would permit the state government to raise only relatively low amounts of revenues. Both the problems are likely to be less severe in the relatively better-off state of Haryana.

12.2.3 Correcting the Imbalances – Inter-governmental Transfers

The vertical and horizontal imbalances inherent in most of the federal fiscal systems have to be resolved (called the process of *equalisation*) in the interest of the stability of the system. Equalisation is a constitutional requirement in some countries, and in some others, a legal obligation. It can also be motivated by a tradition/convention or an implicit general agreement or ‘common will’ as expressed by the legislature. This mechanism for resolution should be a part of

³ For the Union government in India, sale of spectrum has been a lucrative non-tax revenue source.

the system to obviate the need for repeated consideration and policy initiatives for such resolution. In general, this requirement being met by inter-governmental transfers is a common feature in all systems of fiscal federalism, including India.

Apart from resolving the vertical and horizontal imbalances, inter governmental transfers can also serve other purposes. These include:

- a) compensating for benefit spillovers across jurisdictions to maintain efficiency⁴,
- b) to pay for agency functions performed by sub-national governments on behalf of the national government,
- c) to help sub-national governments maintain a minimum level of basic services, and
- d) to incentivise the sub-national governments to fall in line with central planning or development objectives.

Each of these motives for intergovernmental transfers has been explicitly considered and catered to, in the Indian system at some point. For example, the 14th and now the 15th Finance Commissions have linked a State's tax share positively to its area under forests, keeping in mind the environmental and ecological benefit spillovers of forests. Erstwhile Planning Commission and the Plan transfers under its aegis exemplified (d) above.

Inter governmental transfers can be *formula-driven* (amounts for each recipient determined objectively using a set of pre-determined, quantifiable criteria) or *discretionary* (determined on a case-by-case basis). While some amount of discretionary transfer is present in almost all federal systems, too much of it can result in undesirable consequences like loss of sub-national autonomy, inefficient lobbying by recipient governments, and strategic behaviour. Inter governmental transfers generally take one of the two forms: revenue-sharing and grants. Both forms are widely prevalent in various countries of the world including India. Revenue– sharing is usually through a scheme of specified percentage of the total for individual units of sub-national governments, implying varying amounts with variations in the total. In India, the aggregate tax revenue of the Union is shared with States, while other countries may share revenues from individual taxes (Brazil, for example)⁵. Non-tax revenues can also be shared; royalty from various minerals including petroleum crude is shared among different levels of government in several countries.

Grants can be of different types, and their designs are often influenced by the objective of the grants. They can be *conditional (specific purpose) or unconditional (also called general purpose or block grants)*. The latter are generally preferred for correcting horizontal or vertical imbalances. But grants to maintain a minimum level of basic services would obviously be conditional,

⁴ When sub-national governments optimise their public spending by equating benefits with costs, there may be under-provision in the presence of benefit spillovers (positive externalities) – a part of the benefits accruing outside the jurisdiction of the government incurring the expenditure, as the decision may be based on benefits accruing within the jurisdiction only.

⁵ Revenue sharing should be distinguished from revenue base sharing. Base sharing does not require intergovernmental transfers unless collection is centralised by common agreement. Income tax base is shared between the States/Provinces and the Federal (central) government in both the USA and Canada, but that does not entail inter governmental transfers. GST base is shared between the Union and the States in India.

to be spent on specified (basic) services only. Conditional grants can be *matching* (linked to the recipient units' performance in revenue collection or expenditure) or *non-matching*. Matching grants are used when the grantor government wants to modify the grantee government's preferences in favour of the activity supported by the grant. Most of the central grants provided to states under the Centrally Sponsored Schemes are of this type. Further, grants can be *closed-ended* (pre-defined maximum) or *open-ended*.

In the budget documents, grants are reported broadly according to their institutional channel. The first classification is between Plan grants and non-Plan grants. With the discontinuation of central planning, the first category is currently void except for grants relating to Centrally Sponsored Schemes. The second category of non-Plan grants comprises statutory grants (those recommended by the Finance Commission) and other grants (the composition of which can change from time to time).

12.2.4 Sub-national Borrowing

In India, sub-national governments—states and local bodies are permitted by the Constitution to borrow from various sources. These sources include (a) a higher level of government, (b) market borrowings, (c) negotiated loans from various financial institutions including commercial banks, and (d) the central bank of the country and bankers to most of the states—the Reserve Bank of India (RBI). Apart from these, there are other liabilities in the nature of debt that the sub-national governments incur, like Provident Fund contributions collected from their employees. While most of the borrowings are made at their discretion, market borrowings are subject to direct central government control, as per a constitutional provision (Art. 268). Typically, negotiated loans, market borrowings and borrowings from the Union government are long-term loans while loans from commercial banks and those from the RBI are short-term. Loans from the Union government may include some amounts that are simply pass-through debt, actually borrowed from bilateral/multilateral institutions such as the World Bank or Asian Development Bank. Although these loans are negotiated by the lender organisation directly with the beneficiary sub-national government⁶, the actual flow of funds is through the Government of India as the other levels of government are not permitted by the Constitution to borrow from any non-domestic source⁷.

All the state governments in India are subject to their own fiscal responsibility legislations, introduced around the middle of the first decade of this millennium in most of the states. These have the common features, prompted by the Finance Commission, of limitations on revenue deficit, fiscal deficit and the ratio of total debt to Gross State Domestic Product (GSDP). In general, states in India cannot finance their deficit without incurring some kind of debt; thus, the statutory limitation on fiscal deficit automatically implies a restriction on debt. This is important from the point of view of fiscal sustainability of the state finances in

⁶ This is the position after the year 2000. Before that, foreign lenders could not negotiate with the sub-national governments directly as the constitutional restriction was strictly enforced. Also, irrespective of the terms of lending agreed with the original lender, the Union government on-lent the amounts at the same standard terms as the usual lending to the sub-national governments.

⁷ The extent to which sub-national units can access debt from foreign lenders varies between different countries. In Sri Lanka, sub-national governments cannot borrow at all from foreign sources, while Canadian Provinces freely do so.

India, which went through serious stress during the period 1990-2005 leading to the introduction of the fiscal responsibility legislations (FRBMA) in the first place.

Check Your Progress 1

- 1) What do you understand by the term 'fiscal federalism'?

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- 2) List the overall responsibilities of a government. How are these responsibilities suited or assigned to different layers of the Government?

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- 3) To what extent do inter-governmental transfers help to correct the vertical and horizontal imbalances?

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- 4) What are the different sources of sub-national borrowings?

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12.3 INSTITUTIONS OF FEDERALISM IN INDIA

Apart from the different tiers of the government, the institutional structure relating to fiscal federalism in India primarily involves the Finance Commissions at the central and state levels, and to a lesser extent the NITI Aayog⁸. An agency that should have been playing a major role is the Inter-State Council, but it does not in practice. In the present fiscal context, another agency that has assumed importance is the GST Council, empowered by the relevant legislation to deliberate upon and take decisions relating to key issues within the ambit of GST structure in the country and administration.

12.3.1 Finance Commission

Article 280 of the Indian Constitution provides for the apex (and originally the only) Finance Commission empowered to advise the Union Government of the day in matters relating to Centre-State financial relations. The Constitution provides for appointment of a Finance Commission by the President of India (the Chairman and Members, on the advice of the Union Government) every five years or earlier. The Commission is provided with a set of Terms of Reference (ToR) that may include, apart from the constitutionally mandated tasks, any other matter involving centre-State financial relations. The constitutionally mandated tasks at present include, *inter alia*, tax devolution or sharing of central tax revenue with the States (Art. 270 as amended), as also recommending grants-in aid to individual States to cover revenue deficits, for onwards transmission to local bodies, for meeting natural calamities, and for any other reason at its discretion (Art. 275 and 282). The Commission also considers the indebtedness of the Union and the States, and makes recommendations deemed appropriate (Art. 293). It is expected to submit its recommendations in a Report some time before its award implementation period is to begin, to give enough time to the Union government to consider the recommendations and table it in the Parliament along with an Action Taken Report (ATR). Each Commission is disbanded after submitting its report, unless an additional issue is entrusted to it for consideration and recommendations. There have been only rare instances when the Union government has not accepted Finance Commission recommendations; this has been a healthy tradition in the working of Indian fiscal federalism.

State Finance Commissions came into being as a result of 73rd and 74th amendments of the Constitution in 1992 conferring constitutional status to the third tier of government, the urban and rural local bodies. Each State government has its own legislation in this respect, and is expected to appoint the State Finance Commissions at regular intervals as provided in their concerned legislation. The scope of the recommendations covers State-local financial relations, mainly fiscal transfers from the State government to the local bodies.

12.3.2 Planning Commission/Niti Aayog

The erstwhile Planning Commission played a significant role in the area of fiscal federalism in India. It oversaw the State level Five Year Plans– both physical and financial, provided financial assistance for State Plans in terms of both debt and grants, and possibly most importantly, provided a forum for the States to

⁸ Its predecessor, the Planning Commission, played a much more important role– as important as the Finance Commission. Some details are provided in following paragraphs.

come together and discuss issues important to them in the form of National Development Committee (NDC), chaired by the Prime Minister of India. The Planning Commission was set up by an executive order of the Union Government when India adopted the mixed economy model of economic system with central planning. While the system of central planning was preferred one, the Planning Commission was a key institution for economic policy; with the economic policy liberalisation of 1991, its pre-eminence started dwindling, and in 2014, its discontinuation was announced. It was replaced by NITI Aayog, which has so far been a purely advisory body with some amount of responsibilities for monitoring and research. It does not play any direct role in fiscal federalism in India.

Various Ministries of the Government of India including the Ministry of Finance play an important role in the system of fiscal federalism in India. While the Ministry of Finance plays an important role in implementing the Finance Commission recommendations, monitoring FRBM Act implementation, and several other tasks of monitoring and control of States' financial measures, several individual line Ministries are responsible for implementing Centrally Sponsored Schemes relating to their mandate and provide associated transfers to States/ local bodies.

12.3.3 GST Council

As you have learnt in Unit 11, indirect tax structure has undergone a revolutionary change through introduction of a single Tax– Goods and Services Tax (GST) by way of constitutional amendment (Article 279A of the Constitution) made in 2016. Prior to GST, the Central taxes include central excise duty, additional duties of excise, additional duties of customs service tax, surcharges and cesses. Similarly the state taxes were State VAT/ sales tax, central sales tax, purchase tax, entertainment tax, luxury tax, entry tax, taxes on lottery, betting and gambling surcharges and cesses, etc.

This multiplicity of indirect tax structure has been replaced by a single tax i.e. GST structure through the Constitutional Amendment in 2016 providing concurrent powers to both Centre and States to levy GST (Centre to tax sale of goods and States to tax provision of services). The key features of GST are:

- Single Tax (GST)
- Single Tax Administration
- Uniform Law
- Computerised Uniform Procedures

In brief GST Structure in India can be summed up as under:

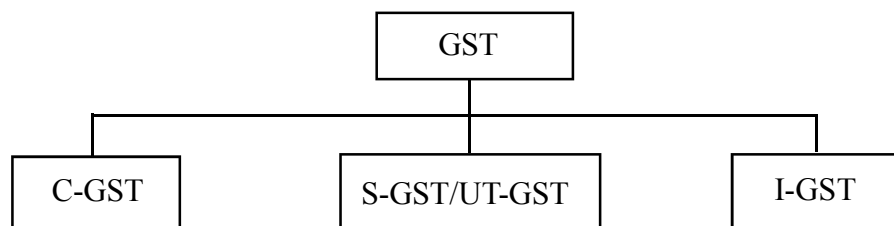


Fig. 12.1: GST Structure in India

Alcohol for human consumption, five petroleum products, Tobacco and entertainment tax have been left outside the purview of GST.

This tax is a major contributor to the tax revenue of both levels of the Government, particularly the States.

The GST Council comprising both State and Union representatives has assumed significance because it is entrusted with the responsibility of providing/ amending/ updating the details with respect to the structure and administration of GST, a tax jointly levied by the centre and the States.

As on 14-5-2019, 94.5 per cent of the total decisions (1064) of the GST Council have already been implemented, which is a significant achievement given the complicated nature and wide area of subjects/issues involved on the fact that most decisions were taken unanimously.

12.4 THE 14TH AND 15TH FINANCE COMMISSIONS

The primary responsibility of the Finance Commission, as mentioned above in the preceding section, relates to recommending fiscal transfers from the Union to sub-national governments. As the transfers to local bodies are also routed through the State governments, it could be taken as Centre-State transfers. The two types of transfers, tax devolution and grants, are different in nature in that grants are recommended in money terms or fixed amounts (for each State), while tax devolution is recommended as the percentage shares of each State in the total tax revenue of the Union net of :

- a) Cost of collection of taxes
- b) Revenues collected in the Union Territories
- c) Exclusions like cess and surcharges as specified in the Constitution.

Usually, Finance Commissions estimate individual States' revenue receipts and current expenditure first, yielding estimates of revenue deficit/surplus⁹. Next, tax devolution is recommended in terms of (i) the share of States as a whole in the distributable tax revenue of the Union and (ii) applicable shares of each State. The Commission itself estimates distributable Union tax revenues for the award period, and applying the shares recommended, it estimates the amount of tax devolution for each State. Selecting the States with pre-devolution revenue deficits, these deficits are reduced by the estimated tax devolution. For only those States which end up with post-devolution revenue deficits, a revenue deficit grant to cover the same is recommended. Other grants are usually recommended independent of this process, based on considerations specific to the nature of the grant recommended. By far, tax devolution outweighs other transfers (grants) in terms of the amounts concerned.

The ToR of the 14th Finance Commission, the last one to have submitted its report at this point, is reproduced in Appendix 12.1. As can be seen, it was asked to consider a large number of issues other than the basic ones enshrined in the

⁹ By choice, Finance Commissions in India have confined themselves to the current account (internationally the term 'current' or 'recurrent' is used to denote receipts or expenditure without any associated future financial flows, but the roughly equivalent term 'revenue' is used in the Indian budgetary parlance) of the budget only. The capital account is not considered by them except when considering indebtedness.

Constitution. It, however, did not make specific recommendations affecting the Centre-State financial flows on all of them. The highlights of its recommendations were as follows.

Its first major recommendation was to raise the share of States as a whole in the net tax revenues substantially. This can be seen with reference to the earlier Finance Commissions' recommendations provided in Table 12.2.

Table 12.2: States' Share in Divisible Pool of Central taxes

Finance Commission	States Share in the Net Proceeds of		
	Income Tax (%)	Union Excise Duties (%)	All Shareable Union Taxes (%)
FC-1 (1952-57)	55	40	
FC-2 (1957-62)	60	25	
FC-3 (1962-66)	66.66	20	
FC-4 (1966-69)	75	20	
FC-5 (1969-74)	75	20	
FC-6 (1974-79)	80	20	
FC-7 (1979-84)	85	40	
FC-8 (1984-89)	85	45	
FC-9-I (1989-90)	85	40	
FC-9-II (1990-95)	85	45	
FC-10 (1995-00)	77.5	47.5	
FC-11 (2000-05)			29.5
FC-12 (2005-10)			30.5
FC-13 (2010-15)			32
FC-14 (2015-20)			42

Before the 11th Finance Commission, Finance Commissions could recommend devolution with respect to two taxes only: income tax (after 1961, personal income tax only) was shareable as per the Constitution while Union excise duty was shareable if the Parliament so desired (it passed a resolution to share the tax). The 10th Finance Commission recommended a change in the system to sharing of all taxes, which was then made feasible with the necessary constitutional amendment; this was implemented with the awards of the 11th Finance Commission onwards. It may be noticed that there is a significant jump in the States' share recommended by the 14th Finance Commission. While this was extensively analysed by commentators, it actually signified a much smaller increase, the rest of it being a compensatory one for the discontinuation of Plan grants and the 14th Finance Commission consciously avoiding certain types of grants awarded by several previous Finance Commissions. This latter observation actually constitutes the second highlight of the 14th Finance Commission awards.

All the recent Finance Commissions had recommended conditional or specific-purpose grants, apart from the constitutionally ordained revenue deficit grants, those for local bodies, and for disaster relief/preparedness. In contrast, the 14th

Finance Commission took the position that other agencies with adequate domain expertise should be tasked with the responsibility of recommending specific purpose, or scheme specific grants. In the process, the transfers recommended by it were overwhelmingly unconditional, enhancing the autonomy of the States to decide the uses of the funds received.

The third highlight related to the use of population data. Several Finance Commissions preceding the 14th had used population data for the year 1971 for scaling purposes as also when population was directly used as a determinant of the transfers, as required by their ToR. This in turn was the result of a resolution of the Parliament. The basic idea was to provide an implicit incentive to States with lower growth of population as compared to the others, or rewarding successful control of population growth. However, its ToR marked a departure from the past several Finance Commissions; while the 14th Finance Commission was asked to continue with the 1971 population as the basic number, the ToR specified that it may consider 'demographic changes' post-1971 also. Accordingly, the 14th Commission used a variable termed 'demographic changes' (post-1971) in their suggested formula to determine tax devolution. Table 12.3 provides the determinants used by a few recent Finance Commissions to provide a context and comparison.

Table 12.3: Components and Weights used in Tax Devolution Formulae

Component	FC 11	FC 12	FC 13	FC 14
Income Distance/Fiscal Capacity	62.5%	50.0%	47.5%	50.0%
Population-1971	10.0%	25.0%	25.0%	17.5%
Area	7.5%	10.0%	10.0%	15.0%
Index of infrastructure	7.5%	-	-	-
Tax Effort	5.0%	7.5%	*	-
Fiscal Discipline	7.5%	7.5%	17.5%	-
Demographic Change (2011 population)	-	-	-	10.0%
Forest Cover	-	-	-	7.5%
* Included in fiscal discipline				

It can be seen that the formula for determination of the shares of individual States in tax devolution recommended by the 14th Finance Commission was different in two other respects. One, it did not include a traditional fiscal discipline/ tax effort variable – justified as providing the appropriate fiscal incentive – in its list of determinants on the ground that the already operational Fiscal Responsibility and Budget Management (FRBM) Acts of different States, and the incentives provided to the States to stay within the parameters defined by the Acts obviated the need for any further incentive. Two, it introduced a new determinant for the first time – the share of a State in total forest cover – in response to one clause of the ToR that stressed “the need to balance management of ecology, environment and climate change consistent with sustainable economic development”.

The fourth and final highlight related to a small variation permitted in the normative fiscal deficit level recommended for compliance with FRBM Act.

The two primary targets of FRBM legislations as recommended by preceding Finance Commissions were zero revenue deficit or a revenue surplus, and a maximum fiscal deficit of 3 per cent of Gross State Domestic Product (GSDP). The 14th Finance Commission allowed a maximum of 0.5 per cent of GSDP as additional fiscal deficit provided the concerned State had:

- a) Revenue deficit = 0;
- b) Debt-GSDP ratio = 25%;
- c) Interest payments = 10% of revenue receipts.

To avail of any additional fiscal deficit limit, a State had to fulfil the condition (a). Fulfilling conditions (b) and (c) entitled a State to 0.25 per cent additional fiscal deficit limit for each, available separately and simultaneously (if both the conditions were fulfilled). Thus, instead of a uniform prescription of 3 per cent fiscal deficit, States had three possible levels of fiscal deficit– 3 per cent, 3.25 per cent and 3.5 per cent, depending on their fulfilling conditions (a), (b), and (c). This partially met the critique of the uniform 3 per cent ceiling as a ‘one size fits all’ approach unsuitable for a large and diverse nation like India, where individual States had different investment needs and their financing requirements through borrowing.

The 15th Finance Commission was appointed in November 2017, and initially asked to submit its report by October 2019, as its award period was to begin from the fiscal year 2020-21. As has become customary, its ToR (see Appendix 12.2) contains several issues over and above the basic constitutionally mandated tasks. Of course, it is not necessary for the Commission to make recommendations on every item of the ToR– it was determined long ago by the Sixth Finance Commission that Finance Commissions were not bound by the ToR. However, they must give due consideration to each item of the ToR, and build in whatever considerations they feel appropriate into their recommendations. Also, an important change in the ToR that generated some controversy was a shift to the 2011 population (as opposed to the 1971 population) as the basic population data for each State. States with relatively greater success in controlling their population felt it to be a disincentive for containing population growth.

First because of the additional ToR to consider and suggest a dedicated financing mechanism for defence and internal security, and then because of the change in the status of the State of Jammu and Kashmir into two Union Territories, the Commission needed and was given a one-year extension. It provided a small first report in 2019, applicable to the fiscal year 2020-21 only. The first report marginally modified the share of the States in the net tax revenue of the Union to 41 per cent (Jammu & Kashmir was not covered any more), and also made some small changes in the tax devolution formula (the main one being the reintroduction of tax effort as a determinant with a small weight, and use of a variable representing Total fertility rate of a State as per 2011 Census data along with population as per 2011 Census). Its full report is expected in October 2020, but the outbreak of the COVID-19 pandemic, and its impact on the finances of the States and the Union, would require reconsideration of its entire approach and resultant computations. Moreover, the Commission has been asked to provide its recommendations for five more years till 2025-26, making it the only Finance Commission so far with its award period covering a total of six years instead of the customary five.

- 1) What is the (Union) Finance Commission? How is it distinct from State Finance Commission?

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- 2) What is the basis for the recommendation of the tax devolution and grants made by the Finance Commission?

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- 3) Discuss the role of GST Council in management and administration of GST jointly levied by the Centre and States.

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- 4) State the highlights of the recommendations of 14th Finance Commission.

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12.5 TRENDS AND ISSUES IN FISCAL FEDERALISM IN INDIA

12.5.1 Centralisation and Vertical Imbalance

Federalism in India has been evolving over time, with the broad structure given by the Constitution proving to be durable. However, the fiscal aspect of it has struggled to align with the political evolution of India. After independence, the country saw a politically dominant central government, with the State

governments basically playing the role of followers, primarily a result of most State governments dominated by the same political party that was in power at the Union level. This political landscape started changing gradually by the 'sixties, and by the mid-seventies, regional parties and others not in power at the centre were challenging the political monopoly, often successfully. The political non-conformity among the Union and States has now become the norm, and this has had implications for fiscal federalism, mainly expressed as the demand from the States for financial independence and autonomy. There were, to be sure, institutional responses to this development. The Planning Commission, for example, shifted from a system of scheme-based discretionary financial support system for State Plans, to a substantively formula-driven, block-grant based system in 1969 with the introduction of the well-known 'Gadgil formula' (later modified a little) designed to reduce micro-management of State Plans and enhance States' autonomy. Similarly, several Finance Commissions have also tried to reduce vertical imbalance as best as they could. But in general, the Union government has not been particularly supportive of greater fiscal – particularly revenue – decentralisation, although there have been a few instances of moving in the direction of greater State level financial autonomy.

Independent analysts have branded the system in India as 'quasi-federalism' because of certain centralising features— the primary one being the power of the national legislature to redefining State boundaries and change the political status of a State. This power has already been exercised a few times. Some other features like residuary powers resting with the Union, and the introduction of central planning through the creation of Planning Commission by the executive, have contributed to this view of a centralised federation. The vertical imbalance in revenue raising powers has also been quoted in this context, although most large federations are characterised by this feature in varying degrees. Because of the persisting need for resources to finance public interventions in a developing India, both the central and the State governments are always trying to garner resources for themselves, and this takes several forms, one of which is to get (or keep, as the case may be) as much as feasible for themselves. It should be noted here that the Union has access to additional sources of funds including deficit financing that the States do not have, and hence the position of the two levels of governments are not symmetrical. The Finance Commissions have generally been sympathetic to the plight of the States and have tried to allocate a fair share of resources to them. But the Union has tried to thwart these efforts often, as can be deduced from the following examples.

- In the early years of independent India, there was only one income tax covering both personal and corporate income tax. In 1961, the relevant Act was overhauled, and the accounts of the Union split the two income taxes into different major heads. This was followed by the position that corporate income tax was now a separate tax, and since the Constitution did not ask for sharing this and only income tax (interpreted to mean just the personal income tax), corporate income tax was not shareable. *De facto* additional resource mobilisation through personal income tax also decreased following this episode until the 10th Finance Commission recommended sharing of all taxes of the Union.
- A recent example of this tug-of-war for resources is provided by the Union government's reaction to the increased tax devolution recommended by the 14th Finance Commission. While a large part of this increase was actually

compensatory in nature consequent to abolition of the Plan transfers and eschewing sector-specific and scheme-based grants, only the increase was highlighted, and was followed by a restructuring of the financing of Centrally Sponsored Schemes such that, the additional financing required from the States practically wiped off whatever little net benefit the 14th Finance Commission had provided to the States.

- A third example relates to the rather liberal use of cess and surcharges by the Union government in recent years, a trend that is still continuing. Suffice it to point out that cess and surcharges are excluded from shareable taxes and have increased from about 10 per cent of gross tax revenues of the Union to 18.55 per cent between 2011-12 and 2019-20.
- A fourth and final example is about mineral royalties payable to States on major minerals¹⁰ extracted from within their jurisdiction. Royalty rates are statutorily required to be reassessed at given intervals, usually to raise them to allow States to share the benefits of rising prices. This feature was really important when royalty rates were specific (i.e., fixed amounts per unit of output), and the central government delayed revisions in the face of fast-rising prices of minerals like iron ore; now that these rates have been changed to *ad valorem* (percentage of value per unit of output), theoretically rate revisions should be less of a problem. However, there are still complaints from States that because major minerals are largely extracted by central public enterprises, the Union government often uses price data for determining value of minerals that underestimate true market value.

As against the above examples, there are some examples of the central government accommodating States' interests too. For instance, in the year 2000, the Union changed its usual practice of lending all foreign assistance in the form of debt or combination of debt and grants under its common terms for lending to States (at that point of time, the rates of interest charged were substantially higher than market rates, and an administrative charge was payable in addition) to 'back-to-back' passing on of such assistance (meaning on the same terms as received from the foreign source). This essentially meant that States could take advantage of the soft terms attached to such assistance, while they also had to bear the exchange risk of foreign-currency denominated loans.

The centralising tendency is visible on the expenditure side also, but more qualitative than quantitative. First, the constitutional provision of the Union dominance in the subjects included in the Concurrent List (decisions by the Parliament overrule any State legislations in these areas) facilitates centralisation by design. This has been expanded with a few cases of constitutional amendment moving subjects from State List to the Concurrent List. Centrally Sponsored Schemes have been, however, a greater irritant in the context of centre-State

¹⁰ Minerals are divided into three categories from the point of view of financial flows relating to them. Crude petroleum is a category by itself; the Union has full jurisdiction on its exploitation with only a royalty payable to the concerned State on onshore production (royalty on offshore production, as in the case of Bombay High oilfields, is collected by the centre). For major minerals like coal, iron ore, bauxite, copper and gypsum, the States have a say in the actual exploitation of mines, and also receive a royalty on the value of minerals extracted. In the case of minor minerals like earth, stones and sand, the States are given full control over their exploitation and royalty collections. The rates of royalty are determined by the Union government for petroleum crude and major minerals.

financial relations. These are centrally initiated and designed schemes relating to subjects in the State domain, funded fully or partially by the Union, the latter usually with matching requirements. Resource-starved State governments cannot afford refusal to participate, but matching grants distort State priorities by pulling in more State resources for the activity supported by the Scheme than would otherwise be the case (see Cullis and Jones, 1992, pp. 307-311 for a theoretical discussion of the effect of different types of grants on recipient governments' expenditure). Administered by central ministries relevant to the coverage of the scheme, in the last two decades, grants under these schemes have outweighed other types of grants. Apart from limiting State autonomy in practice, these grants also modify the regional pattern of equity and the incentive structure built into the Finance Commission transfers. To be sure, there is a place for such conditional matching grants in a federal system; but it is the quantum of these grants that really generate skepticism about their legitimacy in India. These grants have a tendency of proliferating and attempts to limit their number and financial flows in the past have been defeated by the internal dynamics of the governmental processes within the Union government.

12.5.2 Regional Equity and Horizontal Imbalance

India is one of the countries with fairly high levels of regional inequality. Though regional inequality and horizontal imbalance are not exactly the same as the latter refers to the limited context of public finances, there would be a presumption that these two would be highly correlated. This is because the poorer regions would have a smaller revenue base to exploit and greater need for public interventions on account of lower ability of its residents to spend on private goods and services. This is certainly the case in India, if we consider expenditure needs and revenue potentials of the States rather than the actual receipts and expenditures (Sen, 2011). A major objective of the inter-governmental transfers is to reduce vertical imbalances, which can then contribute to reduction in regional inequalities. Admittedly, the latter is determined by several interrelated factors other than the State's public finances, some of which are within the public policy domain. However, the link between development and public policy (implementation of most of which requires financial resources) is summarised in Figure 12.1.

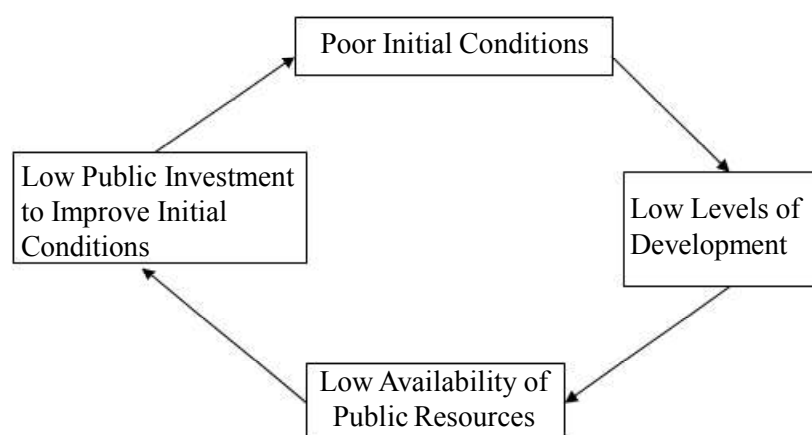


Fig. 12.1: Vicious Cycle of Public Interventions for Development

Source: Reproduced from Sen (2011)

It is this vicious cycle that the system of fiscal federalism is expected to disrupt; unfortunately that has not happened to any appreciable extent. The salient causes may be summarised as follows:

- Various elements of public policy have worked at cross purposes. Empirical studies have shown that among different channels of fiscal transfers, only Finance Commission transfers have been somewhat equalising (inversely related to per capita income of individual States). Earlier Plan assistance, transfers under Centrally Sponsored and Central Plan Schemes and other transfers have no significant relationship with per capita income. Central investments in public sector undertakings also have not been progressive, nor the major budgetary subsidies of the central government or credit flows from the financial institutions (Rao and Sen, 1996). The lack of coordinated public policy aiming to reduce regional disparities has thus witnessed a widening of the disparities over the years.
- Even the Finance Commission transfers have been less equalising than they could have been. Their refusal to consider investment requirements of various States – particularly important for low-income States – even after the discontinuation of the Planning Commission that was expected to attend to this aspect has pushed this consideration out of the agenda for Centre-State financial flows, to the detriment of prospects of dynamic equalisation. Even when considering revenue deficit grants, the receipts and expenditures are estimated using projections on the basis of actual values for a base year and not normative estimates (i.e., revenue potential and expenditure need). Since actual values of expenditure of low-income States are strongly revenue-constrained, this results in underestimating expenditure requirements of these States. In contrast, even a high-income high-spending State can qualify for grants-in-aid if it does not raise adequate revenues in fact. Even the latest report – the First Report of the 15th Finance Commission – uses a similar methodology, building in perverse incentives and negating equalisation.
- The FRBM Act also constrains developmental effort of low-income States. The absolute limit on fiscal deficit (implying a limit on borrowings), makes it difficult for low-income States to borrow and invest beyond the prescribed limit, even if such a course of action is financially viable and required for development purposes.

Thus, with the design of fiscal federalism not providing resources for accelerating the developmental process to the low-income States, they are left to do so with the resources they can raise themselves, which are constrained by the smaller base compared to other States. Widening disparities is a logical outcome of this framework.

Check Your Progress 3

- 1) In what sense India's fiscal federalism is branded as 'quasi-fiscal federalism'?

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- 2) Which aspects of public policy have been operating at a cross-purpose?

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- 3) Identify the critical issues in fiscal federalism in India.

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12.6 LET US SUM UP

Federalism refers to a system having more than one level of governance, each with some autonomy and decision-making power. Under such a system, the powers and responsibilities are distributed among the different layers of the Government. The overall responsibilities of the Government are classified into three groups– resource allocation, distribution of wealth and income, and stabilisation of the economy. The fiscal operations of the Government i.e., revenue raising and public expenditures at different levels play a significant role in discharging the above responsibilities.

Apart from the tiers of the Government, the institutional structure relating to fiscal federalism in India involves primarily the Finance Commission and GST Council at the Central and State level and to a lesser extent the NITI Aayog. The Constitution provides for appointment of a Finance Commission every five years or earlier with a set of terms of reference. The constitutionally mandated tasks at present include inter-alia, sharing of Central tax revenue with States, recommending grants-in-aid to individual States to cover revenue deficits for onward transmission of local bodies, for meeting natural calamities and for any other reason at its discretion. State Finance Commissions are appointed by the State Governments to deal with State local Financial relations, mainly fiscal transfers from State Governments to the local bodies.

The 15th Finance Commission was appointed in November 2017 and its full report is expected by the end of 2020. The commission has been asked to provide its recommendation for five more years till 2025-26.

Centralisation and vertical imbalance, regional inequality and horizontal imbalance difficulties being faced by low-income states in borrowing and investing beyond the prescribed limits due to FRBM set, widening disparities, etc. are issues of concerns with the present design of fiscal federalism.

12.7 TERM-END EXERCISES

- 1) State in brief the principles of Federal finance. How far these principles have been adhered to the Centre-State financial relations in India?
- 2) What is Finance Commission? How is it different from NITI Aayog and GST Council? Evaluate the recommendations of 14th Finance Commission.
- 3) “The question of Centre-State relations has become the focal point of discussion for a number of reasons”. Comment on this statement and point out the reasons for conflict between Center and State.

12.8 KEY WORDS

- Gadgil Formula** : A formula of plan assistance to States adopted since the Fourth Plan (1969-74) which provided that distribution of plan assistance to the States should take five elements into account. This is named after Professor D.R. Gadgil, the then Vice-Chairman of the Planning Commission.
- Gap-filling Approach** : Assistance to States for rectifying imbalances—vertical or horizontal—is essentially in the nature of a device to bridge a budgetary gap. However, the phrase ‘gap-filling approach’ epitomises the practice of Finance Commissions of recommending grants-in-aid to States on the basis of estimated gap between forecasted expenditure and receipts (inclusive of tax shares) on revenue account.
- Horizontal Imbalance, i.e., Horizontal Federal Fiscal Imbalance** : The imbalance between the expenditure requirements and own revenues of different constituents units of a federation mainly on account of differences in fiscal capacities arising out of regional economic disparities. Rectifying horizontal imbalance means promoting regional equalisation.
- Inter-State Council** : In 1990, the Government took the step of invoking the constitutional provision (Article 263) and forming an Inter-State Council charged with the duty of: “(a) inquiring into and advising upon disputes which may have arisen between States; (b) investigating and discussing subjects in which some or all of the States or the Union and one or more of the States, have a common interest; or (c) making recommendations upon any such subject”.
- Statutory Transfer** : Transfer of resources from Centre to States under tax devolution and Article 275 grants-in-aid at the recommendations of the Finance Commission.

: Judged from ratio of tax revenue to State income.

: The non-correspondence between the expenditure requirements of the functions and the extent of revenue raised from the sources assigned to the unit governments as compared to the national government in a federation.

12.9 REFERENCES

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- 9) Twelfth Finance Commission (2003), *Fifty Years of Fiscal Federalism: Finance Commissions of India*, New Delhi: Government of India [This publication contains ToR, composition, summarized approach, main recommendations and action taken report of first 11 Finance Commissions – excellent source for a history of Finance Commissions].
- 10) Source-GST Council.gov.om/sites/default/files/gst.update010719

12.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) See Section 12.1
- 2) See Section 12.2
- 3) See Sub-Section 12.2.2 and 12.2.3
- 4) See Sub-Section 12.2.4

Check Your Progress 2

**Major Development on Union
State Relations**

- 1) See Sub-Section 12.3.1
- 2) See Section 12.4
- 3) See Sub-Section 12.3.3
- 4) See Section 12.4

Check Your Progress 3

- 1) See Sub-Section 12.5.1
- 2) See Sub-Section 12.5.2
- 3) See Section 12.5



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APPENDIX 12.1: TOR OF THE 14TH FINANCE COMMISSION

- “4) The Commission shall make recommendations as to the following matters:
- i) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
 - ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and(iii) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayat and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.
- 5) The Commission shall review the state of the finances, deficit and debt levels of the Union and the States, keeping in view, in particular, the fiscal consolidation road map recommended by the Thirteenth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the Fiscal Responsibility and Budget Management Acts currently in force and while doing so, the Commission may consider the effect of the receipts and expenditure in the form of grants for creation of capital assets on the deficits; and the Commission shall also consider and recommend incentives and disincentives for States for observing the obligations laid down in the Fiscal Responsibility and Budget Management Acts.
- 6) In making its recommendations, the Commission shall have regard, among other considerations, to:
- i) the resources of the Central Government, for five years commencing on 1 April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15;
 - ii) the demands on the resources of the Central Government, in particular, on account of the expenditure on civil administration, defence, internal and border security, debt-servicing and other committed expenditure and liabilities;
 - iii) the resources of the State Governments and the demands on such resources under different heads, including the impact of debt levels on resource availability in debt stressed states, for the five years commencing on 1 April 2015, on the basis of levels of taxation and non-tax revenues likely to be reached during 2014-15;
 - iv) the objective of not only balancing the receipts and expenditure on revenue account of all the States and the Union, but also generating surpluses for capital investment;
 - v) the taxation efforts of the Central Government and each State Government and the potential for additional resource mobilisation to

improve the tax-Gross Domestic Product ratio in the case of the Union and tax-Gross State Domestic Product ratio in the case of the States;

- vi) the level of subsidies that are required, having regard to the need for sustainable and inclusive growth, and equitable sharing of subsidies between the Central Government and State Governments;
 - vii) the expenditure on the non-salary component of maintenance and upkeep of capital assets and the non-wage related maintenance expenditure on plan schemes to be completed by 31 March, 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of the capital assets and the manner of monitoring such expenditure;
 - viii) the need for insulating the pricing of public utility services like drinking water, irrigation, power and public transport from policy fluctuations through statutory provisions;
 - ix) the need for making the public sector enterprises competitive and market oriented; listing and disinvestment; and the relinquishing of non-priority enterprises;
 - x) the need to balance management of ecology, environment and climate change consistent with sustainable economic development; and
 - xi) the impact of the proposed Goods and Services Tax on the finances of Centre and States and the mechanism for compensation in case of any revenue loss.
- 7) In making its recommendations on various matters, the Commission shall generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid; however, the Commission may also take into account the demographic changes that have taken place subsequent to 1971.
- 8) The Commission may review the present Public Expenditure Management systems in place including the budgeting and accounting standards and practices; the existing system of classification of receipts and expenditure; linking outlays to outputs and outcomes; best practices within the country and internationally, and make appropriate recommendations thereon.
- 9) The Commission may review the present arrangements as regards financing of Disaster Management with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.
- 10) The Commission shall indicate the basis on which it has arrived at its findings and make available the State-wise estimates of receipts and expenditure.”

The following additional item was added to the ToR of the Commission vide President's Order published under S.O. No. 1424(E) dated 2 June 2014 (Annex 1.2):

“Para 5 A. The Commission shall also take into account the resources available to the successor or re-organised States on re-organisation of the State of Andhra Pradesh in accordance with the Andhra Pradesh Re-organisation Act, 2014 (6 of 2014) and the Ministry of Home Affairs notification number S.O. 655 (E) dated 4 March, 2014 and make recommendations, for successor or re-organised States, on the matters under reference in this notification”.

APPENDIX 12.2: TOR OF THE 15TH FINANCE COMMISSION

- “4) The Commission shall make recommendations as to the following matters, namely:—
- i) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I, Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;
 - ii) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States by way of grants-in-aid of their revenues under Article 275 of the Constitution for purposes other than those specified in the provisos to clause (1) of that article; and
 - iii) The measures needed to augment the Consolidated Fund of a State to supplement there sources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.
- 5) The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Central Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency. The Commission may also examine whether revenue deficit grants be provided at all.
- 6) While making its recommendations, the Commission shall have regard, among other considerations, to:
- i) The resources of the Central Government and the State Governments for the five years commencing on 1st April 2020 on the basis of the levels of tax and the non-tax revenues likely to be reached by 2024-25. In the context of both tax and non-tax revenues, the Commission will also take into consideration their potential and fiscal capacity;
 - ii) The demand on the resources of the Central Government particularly on account of defence, internal security, infrastructure, railways, climate change, commitments towards administration of UTs without legislature, and other committed expenditure and liabilities;
 - iii) The demand on the resources of the State Governments, particularly on account of financing socioeconomic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities;
 - iv) The impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of the 14th Finance Commission, coupled with the

continuing imperative of the national development programme including New India – 2022;

- v) The impact of the GST, including payment of compensation for possible loss of revenues for 5 years, and abolition of a number of cesses, earmarking thereof for compensation and other structural reforms programme, on the finances of Centre and States; and
 - vi) The conditions that GoI may impose on the States while providing consent under Article 293(3) of the Constitution.
- 7) The Commission may consider proposing measurable performance-based incentives for States, at the appropriate level of government, in following areas:
- i) Efforts made by the States in expansion and deepening of tax net under GST;
 - ii) Efforts and Progress made in moving towards replacement rate of population growth;
 - iii) Achievements in implementation of flagship schemes of Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure;
 - iv) Progress made in increasing capital expenditure, eliminating losses of power sector, and improving the quality of such expenditure in generating future income streams;
 - v) Progress made in increasing tax/non-tax revenues, promoting savings by adoption of Direct Benefit Transfers and Public Finance Management System, promoting digital economy and removing layers between the government and the beneficiaries;
 - vi) Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labour intensive growth;
 - vii) Provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services;
 - viii) Control or lack of it in incurring expenditure on populist measures; and
 - ix) Progress made in sanitation, solid waste management and bringing in behavioural change to end open defecation.
- 8) The Commission shall use the population data of 2011 while making its recommendations.
- 9) The Commission may review the present arrangements on financing Disaster Management initiatives, with reference to the funds constituted under the Disaster Management Act, 2005 (53 of 2005), and make appropriate recommendations thereon.
- 10) The Commission shall indicate the basis on which it has arrived at its findings and make available the Statewise estimates of receipts and expenditure.”

Monetary and Fiscal Policies

Subsequent to the publication of these ToR, a fresh Term of Reference was added for the consideration of the Commission. The Commission was asked “to examine whether a separate mechanism for funding of defence and internal security ought to be set up and if so, how such a mechanism could be operationalised.” Also, the change in the status of Jammu and Kashmir from a State to a Union Territory necessitated changes in the 15th FC methodology, since Union Territories are outside the purview of the Finance Commission.



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