Fourth Semester
BA LLB Paper Code: BA LLB 210
Subject: Economics-II L4 PSDA3 C5

Objective – The objective of this paper is to provide broad understanding of basic concepts of Economics and understanding of relationships between Economics and Law.

Unit-I: Overview of Macro Economics (Lectures-12)

a. Basic Concepts: Stock and Flow, National Product and Domestic Product, Circular Flow of Income, Real and Nominal GNP, Marginal Efficiency of Capital and Marginal Efficiency of Investment, Balance of Trade and Balance of Payments, Exchange Rate
b. Development of Macro Economics: Schools of Thought (Classical, Keynesian and Post-Keynesian)
c. Goals of Macro Economic Policy
d. Business Cycles: Meaning, Phases, Features, Impact on the Economy

Unit-II: Issues in Economic Development (Lectures-12)

a. Concept of Economic Development and Growth, Factors of Economic Development and Obstacles of Economic Development
b. Infrastructure and Development
c. Poverty, Unemployment and Inequalities of income: Concept and Policy Measures
d. Debate on State vs. Market
e. Inclusive Growth

Unit-III: Public Finance (Lectures-08)

a. Concept of Public Finance and Private
b. Tax System: Meaning and Classification
c. Burden of Deficit and Debts
d. Fiscal Policy: Concept, Objective and Instruments
e. Central Budget

Unit-IV: Liberalization, Globalization and Related Issues (Lectures-12)

a. New Economic Policy: Structural Adjustment Programme (SAP)
b. Free Trade and Protection
c. International Institutions: IMF, WB and WTO
d. SEZ, FDI

Unit-I: Overview of Macro Economics

A. Basic Concepts

Stocks and Flows:

Economics, business, accounting, and related fields often distinguish between quantities that are stocks and those that are flows. These differ in their units of measurement. A *stock* variable is measured at one specific time, and represents a quantity existing at that point in time (say, December 31, 2004), which may have accumulated in the past. A *flow* variable is measured over an interval of time. Therefore a flow would be measured *per unit of time* (say a year). Flow is roughly analogous to rate or speed in this sense.

For example, U.S. nominal gross domestic product refers to a total number of dollars spent over a time period, such as a year. Therefore it is a flow variable, and has units of dollars/year. In contrast, the U.S. nominal capital stock is the total value, in dollars, of equipment, buildings, inventories, and other real assets in the U.S. economy, and has units of dollars. The diagram provides an intuitive illustration of how the *stock* of capital currently available is increased by the *flow* of new investment and depleted by the *flow* of depreciation.

Stocks and flows in accounting:

Thus, a stock refers to the value of an asset at a balance date (or point in time), while a flow refers to the total value of transactions (sales or purchases, incomes or expenditures) during a accounting period. If the flow value of an economic activity is divided by t he average stock value during an accounting period d, we obtain a measure of the number of turnovers (or rotations) of a stock in that accounting period. Some accounting entries are normally always represented as a flow (e.g. profit or income), while others may be represented both as a stock or as a flow (e.g. capital).

A person or country might have stocks of money, financial assets, liabilities, wealth, real means of production, capital, inventories, and human capital (or labor power). Flow magnitudes include income, spending, saving, debt repayment, fixed investment, inventory investment, and labor utilization.

Comparing stocks and flows:

Stocks and flows have different units and are thus not *commensurable* – they cannot be meaningfully *compared, equated, added, or subtracted.* However, one may meaningfully take *ratios* of stocks and flows, or multiply or divide them. This is a point of some confusion for some economics students, as some confuse taking ratios (valid) with comparing (invalid).

The ratio of a stock over a flow has units of (units)/(units/time) = time. For example, the debt to GDP ratio has units of years (as GDP is measured in, for example, dollars per y ear whereas debt is measured in dollars), which yields the interpretation of the debt to GDP ratio as "number of years to pay off all debt, assuming all GDP devoted to debt repayment".

The ratio of a flow to a stock has units 1/time. For example, the velocity of money is defined as nominal GDP / nominal money s upply; it has units of (dollars / year) / dollars = 1/year.

In discrete time, the change in a stock variable from one point in time to another point in time one time unit later is equal to th e corresponding flow variable per unit of time. For example, if a country's stock of physical capital on January 1, 2010 is 20 machines and on J anuary 1, 2011 is 23 machines, then the flow of ne t investment during 2010 was 3 machines per year. If it then has 27 machines on January 1, 2012, the flow of net investment during 2010 and 2 011 averaged $3\frac{1}{2}$ machines per year.

National Product and Domestic Product:

Gross national product (**GNP**) is the market value of all the products and serv ices produced inone year by labor and property supplied by the residents of a country. Unlike Gross Domestic Product (GDP), which defines production based on the geographical location of production, GNP allocates production based on ownership.

GNP does not distinguish between qualitative improvements in the state of the technical arts (e.g., increasing computer processing speeds), and quantitative increases in goods (e.g., number of computers produced), and considers both to be forms of "economic growth".

Basically, GNP is the total value of all final goods and services produced within a nation in a particular year, plus income earned by its citizens (including income of those located abroad), minus income of non-residents located in that country. GNP measures the value of goods and services that the country's citizens produced regardless of their location. GNP is one measure of the economic condition of a country, under the assumption that a higher GNP leads to a higher quality of living, all other things being equal.

Gross National Product (GNP) is often contrasted with Gross Domestic Product (GDP). While GNP measures the output generated by a country's enterprises (whether physically located domestically or abroad) GDP measures the total output produced within a country's borders - whether produced by that country's own local firms or by foreign firms.

When a country's capital or labour resources are employed outside its borders, or when a foreign firm is operating in its territory, GDP and GNP can produce different measures of total output. In 2009 for instance, the United States estimated its GDP at $14.119 trillion, and its GNP at $14.265 trillion.

GDP vs GNP:

All attributes | Differences | Similarities

Improve this chart	GDP	GNP
Stands for:	Gross Domestic Product	Gross National Product
Definition:	An estimated value of the total worth of a country's production and services, on its land, by its nationals and foreigners, calculated over the course on one year	An estimated value of the total worth of production and services, by citizens of a country, on its land or on foreign land, calculated over the course on one year
Formula for Calculation:	GDP = consumption + investment + (government spending) + (exports − imports)	GNP = GDP + NR (Net income inflow from assets abroad or Net Income Receipts) - NP (Net payment outflow to foreign assets)
Uses:	Business, Economic Forecasting	Business, Economic Forecasting

Circular Flow of Income:

In economics, the terms circular flow of income or circular flow refer to a simple economic model which describes the reciprocal circulation of income between producers and consumers.[In the circular flow model, the inter-dependent entities of producer and consumer are referred to as "firms" and "households" respectively and provide each other with factors in order to facilitate the flow of income. Firms provide consumers with goods and services in exchange for consumer expenditure and "factors of production" from households. More complete and realistic circular flow models are more complex. They would explicitly include the roles of government and financial markets, along with imports and exports.

Human wants are unlimited and are of recurring nature therefore, production process remains a continuous and demanding process. In this process, household sector provides various factors of production such as land, labor, capital and enterprise to producers who produce by goods and services by coordinating them. Producers or business sector in return makes payments in the

form of rent, wages, interest and profits to the household sector. Again household sector spends

this income to fulfill its wants in the form of consumption expenditure. Business sector supplies them goods and services produced and gets income in return of it. Thus expenditure of one sector becomes the income of the other and supply of goods and services by one section of the community becomes demand for the other. This process is unending and forms the circular flow of income, expenditure and production.

A continuous flow of production, income and expenditure is known as circular flow of income. It is circular because it has neither any beginning nor an end. The circular flow of income involves two basic assumptions:- 1.In any exchange process, the seller or producer receives the same amount what buyer or consumer spends. 2.Goods and services flow in one direction and money payment to get these flow in return direction, causes a circular flow.

Circular flows are classified as: Real Flow and Money Flow. Real Flow- In a simple economy, the flow of factor services from households to firms and corresponding flow of goods and services from firms to households is known to be as real flow.

Assume a simple two sector economy- household and firm sectors, in which the households provides factor services to firms, which in return provides goods and services to them as a reward. Since there will be an exchange of goods and services between the two sectors in physical form without involving money, therefore, it is known as real flow.

Money Flow- In a modern two sector economy, money acts as a medium of exchange between goods and factor services. Money flow of income refers to a monetary payment from firms to households for their factor services and in return monetary payments from households to firms against their goods and services. Household sector gets monetary reward for their services in the form of rent, wages, interest, and profit form firm sector and spends it for obtaining various types of goods to satisfy their wants. Money acts as a helping agent in such an exchange.

Assumptions:

The basic circular flow of income model consists of seven assumptions:

1. The economy consists of two sectors: households and firms.
2. Households spend all of their income (Y) on goods and services or consumption (C). There is no saving (S).
3. All output (O) produced by firms is purchased by households through their expenditure (E).
4. There is no financial sector.
5. There is no government sector.
6. There is no overseas sector.

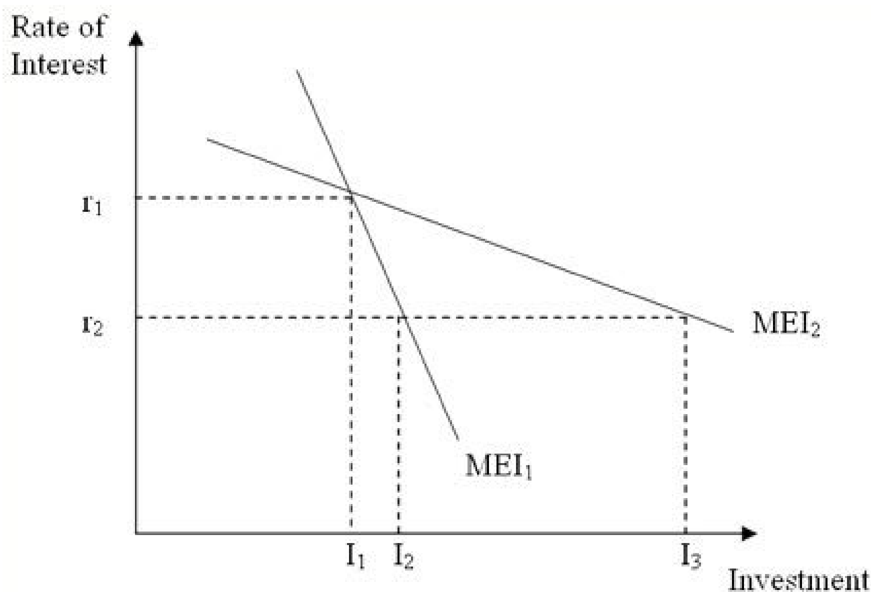
7. It is a closed economy with no exports or imports.

Real and Nominal GNP

The **nominal price** of a good is the cost of the good at the current price level. Changes in nominal prices result directly from changes in the price level due to inflation. While nominal price is an easy concept to understand, real price is a little more complicated. The **real price** of a good is the cost of the good at a base year price level. For example if the cost of a basketball in 2005 was $10 and the current cost of the basketball is $12, we would say the real price of the ball is $10 with base year 2005. The concept of real and nominal is used to evaluate other things such as GDP and interest rates.

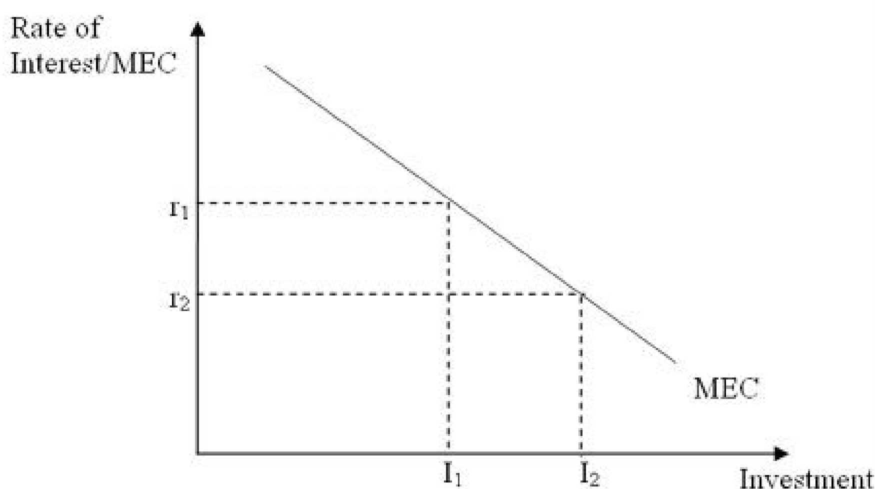
Marginal Efficiency of Investment (MEI) vs. Marginal Efficiency of Capital (MEC)

The MEI curve represents the interest elasticity of demand for investment (or capital goods), or in other words, how responsive investment is to a change in interest rates. Interest rates represent the cost of borrowing. Theoretically, the lower the rate of interest, the cheaper it is for firms to finance investment, and the more profitable the investment will be. Hence, the level of investment will rise.



Keynes instead emphasized the importance of *expectations* (entrepreneurship mood), which is affected by the state of the market for their product (which is in turn determined by factors like political stability, cost of production, conducive business climate etc). The expected rate of returns from investment is measured by Marginal Efficiency of Capital (MEC).

MEC is a downward sloping curve because, as the firm invests more, MEC will fall due to diminishing returns (i.e. the first few projects invested in tend to give a higher rate of returns, with subsequent projects yielding lower and lower returns).



The decision to invest is determined by a comparison of MEC and the opportunity cost of the investment (i.e. interest rate). As long as the MEC is greater than interest rates, firms will invest more (i.e. the project is regarded as worthwhile). It will stop investing when the MEC = i/r. Hence, as seen in the above diagram, if interest rates fall from r1 to r2, projects with lower expected returns, seen previously as unprofitable, will NOW appear viable, and so, more I will occur. This increases I from I1 to I2.

Increasing optimism translates into higher expected returns and the MEC can shift to the right. Similarly, a collapse of business confidence causes a downward revision of future returns and the MEC curve shifts to the left.

Balance of Payment

The Balance of Payments shows countries transactions with the rest of the world. It notes inflows and outflows of money and categorises them into different sections. The different sections of the Balance of Payments are:

Current Account Balance of Payments

Measures transactions for goods and services.(used to be called visible and invisibles) The current account comprises the trade balance (which is trade in goods) and also includes the balance for trade in services.

When people refer to a balance of payments deficit they invariably mean a current account deficit

Financial Account (Capital) Balance of Payments

The financial account measures inflows of capital both short term and long term. This includes

1. foreign direct investment
2. Purchase of securities by investors

In a floating exchange rate a current account deficit must be matched by a surplus on the financial account.

Balance of Payments Crisis

This occurs when the current account deficit cannot be maintained. It means there will be a fall in foreign exchange reserves and the country can no longer attract sufficient capital flows to finance the current account deficit.

The solution to a balance of payments crisis is usually to devalue the currency and slow down consumer spending on imports, usually by causing a recession.

Balance of Trade (BOT)

BOT is the difference between the monetary value of exports and imports of output in an economy over a certain period, measured in the currency of that economy. It is the relationship between a nation's imports and exports

A positive balance is known as a **trade surplus** if it consists of exporting more than is imported; a negative balance is referred to as a **trade deficit** or, informally, a trade gap. The balance of trade is sometimes divided into a goods and a services balance.

Exchange Rate

An **exchange rate** (also known as a **foreign-exchange rate**, **forex rate**, **FX rate** or **Agio**) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency.

For example, an interbank exchange rate of 119 Japanese yen (JPY, ¥) to the United States dollar (US$) means that ¥119 will be exchanged for each US$1 or that US$1 will be exchanged for each

¥119. In this case it is said that the price of a dollar in terms of yen is ¥119, or equivalently that the price of a yen in terms of dollars is $1/119.

Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers where currency trading is continuous: 24 hours a day except weekends, i.e. trading from 20:15 GMT on Sunday until 22:00 GMT Friday. The spot exchange rate refers to the current exchange rate. The forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

In the retail currency exchange market, a different buying rate and selling rate will be quoted by money dealers. Most trades are to or from the local currency. The buying rate is the rate at which money dealers will buy foreign currency, and the selling rate is the rate at which they will sell the currency. The quoted rates will incorporate an allowance for a dealer's margin (or profit) in trading, or else the margin may be recovered in the form of a commission or in some other way. Different rates may also be quoted for cash (usually notes only), a documentary form (such as traveler's cheques) or electronically (such as a credit card purchase). The higher rate on documentary transactions has been justified to compensate for the additional time and cost of clearing the document, while the cash is available for resale immediately. Some dealers on the other hand prefer documentary transactions because of the security concerns with cash.

B. Development of Macro Economics: Schools of Thought (Classical, Keynesian and Post-Keynesian)

Keynesian economics:

Keynesian economics (or **Keynesianism**) is the view that in the short run, especially during recessions, economic output is strongly influenced by aggregate demand (total spending in the economy). In the Keynesian view, aggregate demand does not necessarily equal the productive capacity of the economy; instead, it is influenced by a host of factors and sometimes behaves erratically, affecting production, employment, and inflation
The theories forming the basis of Keynesian economics were first presented by the British economist John Maynard Keynes in his book, *The General Theory of Employment, Interest andMoney*, published in 1936, during the Great Depression. Keynes contrasted his approach to the'classical' economics that preceded his book. The interpretations of Keynes that followed are contentious and several schools of economic thought claim his legacy.

Keynesian economists often argue that private sector decisions sometimes lead to inefficient macroeconomic outcomes which require active policy responses by the public sector, in particular, monetary policy actions by the central bank and fiscal policy actions by the government, in order to stabilize output over the business cycle. Keynesian economics advocates

a mixed economy – predominantly private sector, but with a role for government intervention during recessions.

Keynesian economics served as the standard economic model in the developed nations during the later part of the Great Depression, World War II, and the post-war economic expansion (1945–1973), though it lost some influence following the oil shock and resulting stagflation of the 1970s.The advent of the global financial crisis in 2008 has caused a resurgence in Keynesian thought.

Classical economics:

Classical economics is widely regarded as the first modern school of economic thought. Itsmajor developers include Adam Smith, Jean-Baptist Say, David Ricardo, Thomas Malthus and John Stuart Mill.

Adam Smith's *The Wealth of Nations* in 1776 is usually considered to mark the beginning of classical economics. The school was active into the mid 19th century and was followed by neoclassical economics in Britain beginning around 1870, or, in Marx's definition by "vulgar political economy" from the 1830s. The definition of classical economics is debated, particularly the period 1830–70 and the connection to neoclassical economics. The term "classical economics" was coined by Karl Marx to refer to Ricardian economics – the economics of David Ricardo and James Mill and their *predecessors* – but usage was subsequently extended to include the *followers* of Ricardo.

Classical economists claimed that free markets regulate themselves, when free of any intervention. Adam Smith referred to a so-called invisible hand, which will move markets towards their natural equilibrium, without requiring any outside intervention.

As opposed to Keynesian economics, classical economics assumes flexible prices both in the case of goods and wages. Another main assumption is based on Say's Law: supply creates its own demand - that is, aggregate production will generate an income enough to purchase all the output produced; this implicitly assumes, in contrast to Keynes, that there will be net saving or spending of cash or financial instruments. Another postulate of classical economics is the equality of savings and investment, assuming that flexible interest rates will always maintain equilibrium.

Differences Between Classical & Keynesian Economics:

Economics is the quantitative and qualitative study on the allocation, distribution and production of economic resources. Economics often studies the monetary policy of a government and other information using mathematical or statistical calculations. Qualitative analysis is made by making judgments and inferences from fiscal information. Two economic schools of thought are classical and Keynesian. Each school takes a different approach to the economic study of monetary policy, consumer behavior and government spending. A few basic distinctions separate these two schools.

Basic Theory:

Classical economic theory is rooted in the concept of a laissez-faire economic market. A laissez-faire--also known as free--market requires little to no government intervention. It also allows individuals to act according to their own self interest regarding economic decisions. This ensures economic resources are allocated according to the desires of individuals and businesses in the marketplace. Classical economics uses the value theory to determine prices in the economic market. An item’s value is determined based on production output, technology and wages paid to produce the item. Keynesian economic theory relies on spending and aggregate demand to define the economic marketplace. Keynesian economists believe the aggregate demand is often influenced by public and private decisions. Public decisions represent government agencies and municipalities. Private decisions include individuals and businesses in the economic marketplace.

Government Spending:

Government spending is not a major force in a classical economic theory. Classical economists believe that consumer spending and business investment represents the more important parts of a nation& economic growth. Too much government spending takes away valuable economic resources needed by individuals and businesses. To classical economists, government spending and involvement can retard a nation’s economic growth by increasing the public sector

and decreasing the private sector. Keynesian economics relies on government spending to jumpstart a nation’s economic growth during sluggish economic downturns. Similar to classical economists, Keynesians believe the nation’s economy is made up of consumer spending, business investment and government spending. However, Keynesian theory dictates that government spending can improve or take the place of economic growth in the absence of consumer spending or business investment.

Short vs. Long-term Affects

Classical economics focuses on creating long-term solutions for economic problems. The effects of inflation, government regulation and taxes can all play an important part in developing classical economic theories. Classical economists also take into account the effects of other current policies and how new economic theory will improve or distort the free market environment. Keynesian economics often focuses on immediate results in economic theories. Policies focus on the short-term needs and how economic policies can make instant corrections to a nation& rsquo; s economy. This is why government spending is such a key cog of Keynesian economics. During economic recessions and depressions, individuals and businesses do not usually have the resources for creating immediate results through consumer spending or business investment. The government is seen as the only force to end these downturns through monetary or fiscal policies providing instant economic results.

Post Keynesian

Post-Keynesian economics refers to a collection of emerging schools within macroeconomics that are attempting to "go back to the basics" of the work of John Maynard Keynes. In the post-World War II era, after Keynes died, his theories merged with more neoclassical-oriented thought and became the schools called New Keynesianism and neo-Keynesianism. These schools sought to root Keynes' ideas in a microeconomic approach. Post-Keynesians, by focusing more on macro-effects, have in one way moved closer back to Keynes, but have also introduced many ideas not found in his work.

Many Post-Keynesians either fall into the "circuitists" or the "neo-chartalists" (sometimes called "modern monetary theory"), though these two groups aren't mutually exclusive and there is a good deal of overlap. Both reject the idea of neutral money. Circuitists generally emphasize the role of credit money as primary (loans made by banks) while neo-chartalists emphasize the role of high-powered money (hard cash and credit lent to banks by the Federal Reserve). Circuitists base their theories on Augusto Graziani's *Theory of the Monetary Circuit* as well as Keynes. Neo-chartalists base their theories on the original chartalist ideas of Abba Lerner and their later reformulation by Warren Mosler.

Although the Post-Keynesians are a diverse group, many share similar beliefs, some of which may include:

- The government as a sovereign issuer of money. This is a commonly known fact, but important especially to neo-chartalists as they draw many implications from it. They believe that most people, the government included, act as if the nation still ran on the gold standard.
- The government doesn't collect taxes or spend them. Taxes "destroy" currency and spending "creates" currency because fiat currency is only backed by the government's faith. So taxing money out of the economy is the same as destroying it. (The money, not the economy)
- Financial transactions always create an offsetting liability. There are always three parties, not two, involved in a transaction: buyer, seller, and bank. This is because all money is credit. Cash ("high-powered money") is a liability of the Fed, credit (like credit cards) is a liability of your bank, and that credit is created by loaning out against the bank's reserve of high-powered money.
- Rejection of "crowding out." Government spending does not crowd out monetary resources because spending "creates" more money.
- Rejection of the money multiplier. Banks can loan reserves to each other or get money from the Fed's discount window, making the money multiplier a formality without much real meaning.
- Rejection of equilibrium. Post-Keynesians believe the market is dynamic and rarely if ever in equilibrium (i.e., the market is never fully efficient).
- Rejection of a natural level of unemployment.
- Rejection of homo economicus.
- Government spending is limited by high levels of inflation, not tax revenue.
- Importance of the credit cycle as part of the business cycle.

Which has led many Post-Keynesians to support policies such as:

- Full employment at all times. Keynesianism on 'roids. Some support a job guarantee, whereby the government hires unemployed workers either directly or indirectly through private contracting.
- Stricter financial regulations.
- Restructuring credit markets and debt (debt-to-equity swaps).
- Low taxes except in cases of increased inflation to "destroy" excess currency. (Liberals that don't like taxes!)
- Unbalanced budgets as a counter-cyclical policy. Deficits when unemployment is high, surpluses when inflation is high. (Much like Keynes.)
- Limitations on private debt.

C. Goals of macroeconomic policy:

The three primary macroeconomic policy goals are economic growth, low unemployment, and low

inflation.

Economic growth is an increase in a country's standard of living. Unemployment is the condition of wanting, but not having, a paid job. Inflation is a general increase in the price level, which is the general level of prices for goods and services in an economy. A price index is used to measure the price level. All three goals are important because of their influence on the standard of living. Economic growth is the primary determinant of the standard of living, however, and is thus the ultimate macroeconomic goal.

D. Business Cycle:

The term "business cycle" (or economic cycle or boom-bust cycle) refers to economy-wide fluctuations in production, trade, and general economic activity. From a conceptual perspective, the business cycle is the upward and downward movements of levels of GDP (gross domestic product) and refers to the period of expansions and contractions in the level of economic activities (business fluctuations) around a long-term growth trend .

Phases of Business Cycles:
Generally, the following phases of business cycles have been distinguished:
1. Expansion (Boom, Upswing or Prosperity)

2. Peak (upper turning point)

3. Contraction (Downswing, Recession or Depression)

4. Trough (lower turning point)

The four phases of business cycles have been shown in Fig. 27.1 where we start from trough or depression when the level of economic activity i.e., level of production and employment is at the lowest level. With the revival of economic activity the economy moves into the expansion phase, but due to the causes explained below, the expansion cannot continue indefinitely, and after reaching peak, contraction or downswing starts. When the contraction gathers momentum, we have

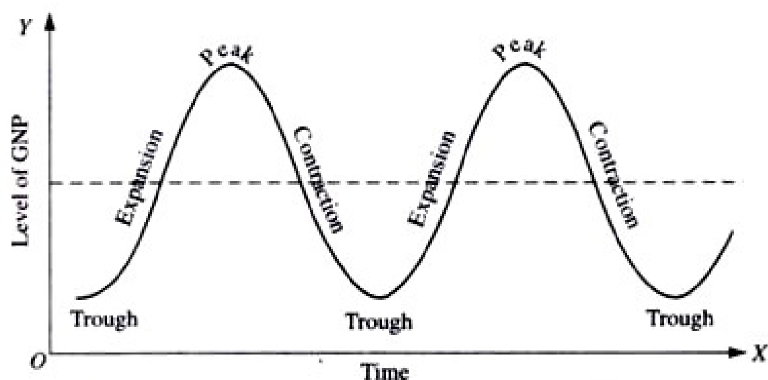


Fig. 27.1. *Four Phases of Business Cycles without Growth Trend*

a depression. The downswing continues till the lowest turning point which is also called trough is reached. In this way cycle is complete. However, after remaining at the trough for some time the economy revives and again the new cycle starts.

Haberler in his important work on business cycles has named the four phases of business cycles as:

(1) Upswing,

(2) Upper turning point,

(3) Downswing, and

(4) Lower turning point

There are two types of patterns of cyclic changes. One pattern is shown in Fig. 27.1 where fluctuations occur around a stable equilibrium position as shown by the horizontal line. It is a case of dynamic stability which depicts change but without growth or trend.

The second pattern of cyclical fluctuations is shown in Fig. 27.2 where cyclical changes in economic activity take place around a growth path (i.e., rising trend). J.R. Hicks in his model of business cycles explains such a pattern of fluctuations with long-run rising trend in economic activity by imposing factors such as autonomous investment due to population growth and technological progress causing economic growth on the otherwise stationary state. We briefly explain below various phases of business cycles.

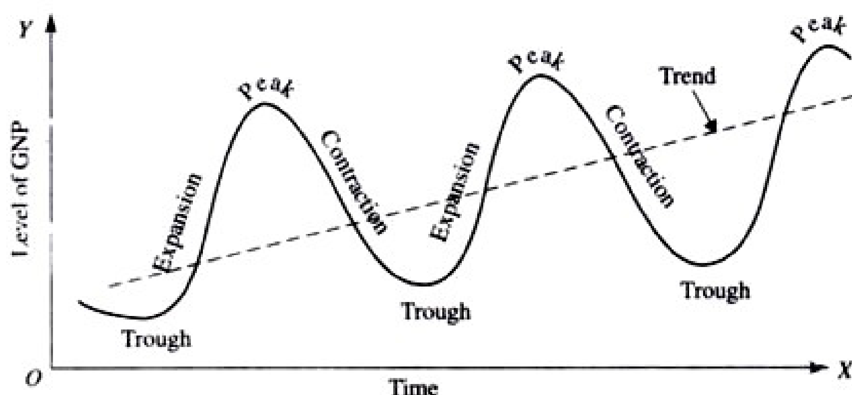


Fig. 27.2. *Cycles with Trend (i.e., Growth)*

Expansion and Prosperity:

In its expansion phase, both output and employment increase till we have full-employment of resources and production is at the highest possible level with the given productive resources. There is no involuntary unemployment and whatever unemployment prevails is only of frictional and structural types.

Thus, when expansion gathers momentum and we have prosperity, the gap between potential GNP and actual GNP is zero, that is, the level of production is at the maximum production level. A good amount of net investment is occurring and demand for durable consumer goods is also high. Prices also generally rise during the expansion phase but due to high level of economic activity people enjoy a high standard of living.

Then something may occur, whether banks start reducing credit or profit expectations change adversely and businessmen become pessimistic about future state of the economy that bring an end to the expansion or prosperity phase.

As shall be explained below, economists differ regarding the possible causes of the end of prosperity and start of downswing in economic activity. Monetarists have argued that contraction in bank credit may cause downswing.

Keynes have argued that sudden collapse of expected rate of profit (which he calls marginal efficiency of capital, MEC) caused by adverse changes in expectations of entrepreneurs lowers investment in the economy. This fall in investment, according to him, causes downswing in economic activity.

Contraction and Depression:

As stated above, expansion or prosperity is followed by contraction or depression. During contraction, not only there is a fall in GNP but also level of employment is reduced. As a result, involuntary unemployment appears on a large scale. Investment also decreases causing further fall in consumption of goods and services.

At times of contraction or depression prices also generally fall due to fall in aggregate demand. A significant feature of depression phase is the fall in rate of interest. With lower rate of interest people's demand for money holdings increases.

There is a lot of excess capacity as industries producing capital goods and consumer goods work much below their capacity due to lack of demand. Capital goods and durable consumer goods industries are especially hit hard during depression. Depression, it may be noted, occurs when there is a severe contraction or recession of economic activities. The depression of 1929-33 is still remembered because of its great intensity which caused a lot of human suffering.

Trough and Revival:

There is a limit to which level of economic activity can fall. The lowest level of economic activity, generally called trough, lasts for some time. Capital stock is allowed to depreciate without replacement. The progress in technology makes the existing capital stock obsolete.

If the banking system starts expanding credit or there is a spurt in investment activity due to the emergence of scarcity of capital as a result of non-replacement of depreciated capital and also because of new technology coming into existence requiring new types of marines and other capital goods. The stimulation of investment brings about the revival or recovery of the economy.

The recovery is the turning point from depression into expansion. As investment rises, this causes induced increase in consumption. As a result industries start producing more and excess capacity is now put into full use due to the revival of aggregate demand. Employment of labour increases and rate of unemployment falls. With this the cycle is complete.

Features of Business Cycles:

Though different business cycles differ in duration and intensity they have some common features which we explain below:

1. Business cycles occur periodically. Though they do not show same regularity, they have .some distinct phases such as expansion, peak, contraction or depression and trough. Further the duration of cycles varies a good deal from minimum of two years to a maximum of ten to twelve years.

2. Secondly, business cycles are Synchronic. That is, they do not cause changes in any single industry or sector but are of all embracing character. For example, depression or contraction occurs simultaneously in all industries or sectors of the economy. Recession passes from one industry to another and chain reaction continues till the whole economy is in the grip of recession. Similar process is at work in the expansion phase, prosperity spreads through various linkages of input-output relations or demand relations between various industries, and sectors.

3. Thirdly, it has been observed that fluctuations occur not only in level of production but also simultaneously in other variables such as employment, investment, consumption, rate of interest and price level.

4. Another important feature of business cycles is that investment and consumption of durable consumer goods such as cars, houses, refrigerators are affected most by the cyclical fluctuations. As stressed by J.M. Keynes, investment is greatly volatile and unstable as it depends on profit expectations of private entrepreneurs. These expectations of entrepreneurs change quite often making investment quite unstable. Since consumption of durable consumer goods can be deferred, it also fluctuates greatly during the course of business cycles.

5. An important feature of business cycles is that consumption of non-durable goods and services does not vary much during different phases of business cycles. Past data of business cycles reveal that households maintain a great stability in consumption of non-durable goods.

6. The immediate impact of depression and expansion is on the inventories of goods. When depression sets in, the inventories start accumulating beyond the desired level. This leads to cut in production of goods. On the contrary, when recovery starts, the inventories go below the desired level. This encourages businessmen to place more orders for goods whose production picks up and stimulates investment in capital goods.

7. Another important feature of business cycles is profits fluctuate more than any other type of income. The occurrence of business cycles causes a lot of uncertainty for businessmen and makes it difficult to forecast the economic conditions. During the depression period profits may even become negative and many businesses go bankrupt. In a free market economy profits are justified on the ground that they are necessary payments if the entrepreneurs are to be induced to bear uncertainty.

8. Lastly, business cycles are international in character. That is, once started in one country they spread to other countries through trade relations between them. For example, if there is a recession in the USA, which is a large importer of goods from other countries, will cause a fall in demand for imports from other countries whose exports would be adversely affected causing recession in them too. Depression of 1930s in USA and Great Britain engulfed the entire capital world.

Unit II- Issues in Economic Development

A.Concept of Economic Growth and Development

Economic Growth is a narrower concept than economic development. It is an increase in a country's real level of national output which can be caused by an increase in the quality of resources (by education etc.), increase in the quantity of resources & improvements in technology or in another way an increase in the value of goods and services produced by every sector of the economy. Economic Growth can be measured by an increase in a country's GDP(gross domestic product).

Economic development is a normative concept i.e. it applies in the context of people's sense of morality (right and wrong, good and bad). The definition of economic development given by Michael Todaro is an increase in living standards, improvement in self- esteem needs and freedom from oppression as well as a greater choice.

B. Factors of Economic Development

Determinants (Factors) Which Influence the Economic Development of a Country are as follows:

There are mainly two types of determinants (factors) which influence the economic development of a country.

A.Economic Factors

1. **Capital Formation:**
The strategic role of capital in raising the level of production has traditionally been acknowledged in economics. It is now universally admitted that a country which wants to accelerate the pace of growth, has m choice but to save a high ratio-of its income, with the objective of raising the level of investment. Great reliance on foreign aid is highly risky, and thus has to be avoided. Economists rightly assert that lack of capital is the principal obstacle to growth and no developmental plan will succeed unless adequate supply of capital is forthcoming.

2. **Natural Resources:**
The principal factor affecting the development of an economy is the natural resources. Among the natural resources, the land area and the quality of the soil, forest wealth, good river system, minerals and oil-resources, good and bracing climate, etc., are included. For economic growth, the existence of natural resources in abundance is essential. A country deficient in natural resources may not be in a position to develop rapidly. In fact, natural resources are a necessary condition for economic growth but not a sufficient one. Japan and India are the two contradictory examples.
According to Lewis, "Other things being equal man can make better use of rich resources than they can of poor". In less developed countries, natural resources are unutilized, under-utilized or mis- utilized. This is one of the reasons of their backwardness. This is due to economic backwardness and lack of technological factors.
According to Professor Lewis, "A country which is considered to be poor in resources may be considered very rich in resources some later time, not merely because unknown resources are discovered, but equally because new methods are discovered for the known

resources". Japan is one such country which is deficient in natural resources but it is one of the advanced countries of the world because it has been able to discover new use for limited resources.

3. **Marketable Surplus of Agriculture:**
   Increase in agricultural production accompanied by a rise in productivity is important from the point of view of the development of a country. But what is more important is that the marketable surplus of agriculture increases. The term 'marketable surplus' refers to the excess of output in the agricultural sector over and above what is required to allow the rural population to subsist.
   The importance of the marketable surplus in a developing economy emanates from the fact that the urban industrial population subsists on it. With the development of an economy, the ratio of the urban population increases and increasing demands are made on agriculture for foodgrains. These demands must be met adequately; otherwise the consequent scarcity of food in urban areas will arrest growth.
   In case a country fails to produce a sufficient marketable surplus, it will be left with no choice except to import foodgrains which may cause a balance of payments problem. Until 1976-77, India was faced with this problem precisely. In most of the years during the earlier planning period, market arrivals of foodgrains were not adequate to support the urban population.
   If some country wants to step-up the tempo of industrialization, it must not allow its agriculture to lag behind. The supply of the farm products particularly foodgrains, must increase, as the setting-up of industries in cities attracts a steady flow of population from the countryside.

4. **Conditions in Foreign Trade:**
   The classical theory of trade has been used by economists for a long time to argue that trade between nations is always beneficial to them. In the existing context, the theory suggests that the presently less developed countries should specialize in production of primary products as they have comparative cost advantage in their production. The developed countries, on the contrary, have a comparative cost advantage in manufactures including machines and equipment and should accordingly specialize in them.
   In the recent years, a powerful school has emerged under the leadership of Raul Prebisch which questions the merits of unrestricted trade between developed and under-developed countries on both theoretical and empirical grounds.
   Foreign trade has proved to be beneficial to countries which have been able to set-up industries in a relatively short period. These countries sooner or later captured international markets for their industrial products. Therefore, a developing country should not only try to become self-reliant in capital equipment as well as other industrial products as early as possible, but it should also attempt to push the development of its industries to such a high level that in course of time manufactured goods replace the primary products as the country's principal exports.

In countries like India the macro-economic interconnections are crucial and the solutions of the problems of these economies cannot be found merely through the foreign trade sector or simple recipes associated with it.

5. **Economic System:**
The economic system and the historical setting of a country also decide the development prospects to a great extent. There was a time when a country could have a laissez faire economy and yet face no difficulty in making economic progress. In today's entirely different world situation, a country would find it difficult to grow along the England's path of development.
The Third World countries of the present times will have to find their own path of development. They cannot hope to make much progress by adopting a laissez faire economy. Further, these countries cannot raise necessary resources required for development either through colonial exploitation or by foreign trade. They now have only two choices before them:
i) They can follow a capitalist path of development which will require an efficient market system supported by a rational interventionist role of the State.
ii) The other course open to them is that of economic planning.

Obstacles of Economic Development

According to Thomas Shea the four important barriers to economic development in India an context are caste, pattern of land tenure, population growth, and property laws (which lead to fragmentation of landholdings).

The basic obstacles pointed out by A.R. Desai (1959:130) are:

(a) The social and institutional framework and values inherited from the past (i.e., caste system); and

(b) Persistence of backward types of loyalties.

The caste system though has been theoretically and juridical abol-ished by the Constitution of India, yet its significance in real life, its influence on the economic development, its effect upon the patterns of property relations and patterns of consumption, and its impress upon the configurations of power structure in the economic, political, social and cultural fields are still not properly comprehended and hence gravely un-derestimated.

Caste prevents mobility of people so essential for dynamic economic development. It prevents certain groups from taking to certain vocations, certain patterns of economic behaviour, and certain forms of consumption.

It has been found that most of the controlling positions in economy, administration and cultural pursuits are monopolised by a few castes all over India. In fact, a few castes control the destiny of most peo-ple of the country, leading to caste and regional tensions and social unrest. This unrest becomes the cause of and keeps alive a bitter competitive struggle among the privileged

groups themselves as well as between them and the underprivileged groups. This has a detrimental effect on the devel-opment of a healthy national economy.

Besides caste (which inhibits occupational and social mobility), some important barriers in economic development of India have been identified as joint family system, communalism, regionalism and linguism. It has also come to be accepted that changes in the caste system have made de-velopment possible. Since Gunnar Myrdal had not given importance to changes in social institutions like caste, family, etc., as also to their func-tional aspects in the analysis of development, his analysis of economic development has been described as negative, patchy and disjointed.

Another sociological implication is the persistence of backward types of loyalties resulting into factionalism and division of the Indian people into groups with petty egos, to the detriment of the growth of a highly developed national consciousness.

Some types of loyalties that very much persist (besides the caste loyalty) in India are kinship loyalties, regional identifications and religious attachment. These divisions tend to inhibit the development of a feeling of unity in the society and of identify among its members. The normative pressure rooted in such an environment pro-foundly affects the conduct of the individual in external situations and relations.

A. R. Desai further holds that this parochial mentality, together with the old outmoded institutions, obstructs the proper eco-nomic development in a number of ways:

(i) It leads to nepotism;

(ii) It results into the growth of the harmful practices of unproductive invest-ment patterns and wrong consumption patterns;

(iii) It generates distorted attitudes to work, efficiency, vocations and allocation of resources; and

(iv) It obstructs the growth of those mores and sanctions which are basic to a developing economy in modern times, namely, mores and sanctions founded on law, respect for personality, concept of equal citizenship, etc.

The barriers to economic development in India as given by Yogendra Singh (1973) are:

(i) Transcendence (according to which legitimation of tra-ditional values cannot be challenged);

(ii) Holism (according to which the relation between individual and society (or group) is such that individual subordinates his rights and aspirations to that of society's welfare; it also means precedence to collectivity over the individual);

(iii) Hierarchy (stratification in caste occupation and social status); and

(iv) Continuity (belief in rebirth and karma, etc.).

B. Infrastructure and Development

The relationship between infrastructure and economic development lies in the service that infrastructure contributes to the growth of the economy. That is to say that adequate infrastructure serves as bedrock to facilitate speedy economic development. Countries without

adequate infrastructure may find that economic development does not occur at the same pace and level as in countries with a solid infrastructural network.

Infrastructure may be either hard or soft. Examples of hard infrastructure include pieces like airports, paved roads, shipping harbors, canals, well-constructed sewers and power plants. Examples of soft infrastructure include facets like a structured criminal justice system, telephone networks, Internet and a well-developed educational system. It is easy to see the link between infrastructure and economic development just by analyzing each of the components of infrastructural framework.

An example of such a link between infrastructure and economic development can be seen in the importance of a solid transportation system to any meaningful economic development. People need to move around in pursuit of various daily concerns. Parts of these concerns include work-related matters and business opportunities. In countries with good transportation systems, it is easy to move raw materials from the source to the production plants. It is also easy to move the finished products from the various production plants to the warehouses.

C. Poverty, Unemployment and Inequalities of income: Concept and Policy Measures

Poverty means the state of being extremely poor or the state of being inferior in quality or insufficient in amount.

It is a condition where people's basic needs for food, clothing, and shelter are not being met. Poverty is generally of two types: (1) Absolute poverty and (2) Relative poverty.

Absolute poverty or **destitution** involves a lack of basic necessities including food, clothingsanitation, shelter, health care and education.
[The countries should try to eradicate (remove) this from the country]

Relative poverty or economic inequality occurs when people have less income than other people in the country/unable to participate fully in the normal activities of their society.

[The countries should try to reduce this with in the country]

Measures to reduce poverty

The major measures to reduce the poverty are 1) improve health, Education and industrialisation (especially of primary sector).

Health: Long run economic growth can only be achieved through increases in capital (factors that increase productivity), both human and physical, and technology. Improving human capital, in the form of health, is needed for economic growth. Impart knowledge on the cost effectiveness of healthcare.

Education**:** By increasing the education facilities, create awareness in the people to get their rights. More technical education enables people to start their own technical business and many of them can go overseas to earn foreign exchange for the country.

Industrialization: Most of the developing countries are depending on primary sector with the majority of its labor force associated with it and generate the major percent of GDP from it . The latest and state of the art technologies for agriculture are still not being used in these countries. Industrialization can change the fate of the people. If government start an industrialization with incentives [such as tax free zones]to install new industries labour to move to these industries. This will force land owners to pay extra wages to get their work. Similarly it will also push them to use the latest technology to improve the yield. It is a reality and experience that when an industry starts in a rural area; the wages in that locality increases because the people have the opportunity to work in that industry.

Following are some other measures to reduce poverty.

Welfare Projects, Compulsory education, Genetically Modified Food Production, Small Loans, Debt Relief measures, Empowering Women, Human rights & Gender Equality, Projects on Climate Changes, End Foreign Aid, Good Governance, Good tax systems, Law for Minimum wage and Policies to reduce unemployment such as job creation schemes, stimulus to aggregate demand, Active labour market policies, re-training schemes, and Welfare-to-work schemes. These measures also can help to reduce inequality of income and wealth and thereby reduce the poverty

UNEMPLOYMENT:

Definition of Unemployment: An important part of the definition of unemployment is to know what it means to be unemployed. Unemployment reflects someone who is not working but is searching for work. Thus the unemployment rate measure people looking for work.

The "Natural Rate of Unemployment": this is the rate of unemployment that economy will have in the long run. Think of it as the average long run rate of unemployment. For the US, the Natural Rate of Unemployment would be around 5% to 6%.

Conclusion from the Labor Market: The market for labor theory suggests that wages should adjust so that the labor market is in equilibrium. Equilibrium means the supply of labor (people who want jobs) is in balance with the demand for labor (employers offering jobs). This means if the labor market is in equilibrium, there should be no unemployment. One of the important goals

of Chapter 10 is to explain why there is unemployment in the long run in an economy. To explain why there is a natural rate of unemployment.

Types of Unemployment:

There are four types of unemployment.

- Seasonal Unemployment: This is unemployment that happens at the same time every year due to seasonality.
- Cyclical Unemployment: This unemployment that rises and falls over time. It's a temporary deviation from the long run amount of unemployment. When you look at the unemployment rate over time, the most prominent behavior is for the unemployment rate to rise and fall cyclically. Cyclical Unemployment is the unemployment that deviates from the Natural Rate. Since cyclical unemployment is temporary, discussion of the causes of it are dealt with in the chapter on Business Cycles.
- Frictional Unemployment: This is unemployment that occurs naturally and in the long run. What causes frictional unemployment is discussed below. Frictional unemployment is one thing that contributes to a natural rate of unemployment.
- Structural Unemployment: This too is unemployment that occurs in the long run and contributes to the natural rate. More on this below

Structural Unemployment:

The definition of structural unemployment in the definition section of the study guide is a little different than what is explained in the theory. The theory is that there is something in an economy that prevents wages from adjusting down to equilibrium. If wages are above equilibrium level, then the supply of labor will exceed the demand for labor. There will be a surplus of workers which means there's unemployment. With structural unemployment, there isn't a job for everyone. Examples of structural unemployment causes would be minimum wage laws, "efficiency wage" theory, and labor unions.

Efficiency wage theory is the idea that businesses will offer above equilibrium wage rate. Businesses might do this for a variety of reasons including attracting better workers or making workers more loyal. Labor unions can also raise wages above equilibrium, but this would only cause unemployment for an entire economy if the labor union(s) controlled most wages in that economy. In the US, labor unions control a small fraction of wage rates so labor unions can't cause much structural unemployment in the US.

Frictional Unemployment:

Frictional unemployment model builds upon the market for labor. It assumes that equilibrium wages ensure that supply and demand are in balance. That is, there is a job

for everyone. The model of frictional unemployment builds on this by adding two other conditions. First, even though there is a job for everyone, those jobs are constantly changing. The book uses the term "sectoral shift" meaning a change in demand across different parts (or sectors) of the economy. Others would say that an economy is "dynamic" meaning constantly changing.

The other added condition is that it takes time to find a job. Even though there's a job for everyone, some of the jobs will change, and it will take awhile before a person finds the new job. This creates a constant pool of unemployed people – a natural rate of unemployment.

The quantity of frictional unemployment is dependent upon how long someone takes to find a job. If people can find jobs (or match) faster, the natural rate of unemployment will be lower. The internet with all those job sites may have reduced the natural rate of unemployment. On the other hand, anything that causes someone to look longer will raise the rate of unemployment. Unemployment benefits, payments to individuals unemployed for the proper reasons, will cause people to look longer for work and thus create a slightly higher unemployment rate.

Inequality

Economic inequality, also known as income inequality, wealth inequality, gap between rich and poor, gulf between rich and poor and contrast between rich and poor, refers to how economic metrics are distributed among individuals in a group, among groups in a population, or among countries. Economists generally think of three metrics of economic disparity: wealth (wealth inequality), income (income inequality), and consumption. The issue of economic inequality can implicate notions of equity, equality of outcome, and equality of opportunity.

Causes of Inequalities:

There are several causes which give rise to inequality of incomes in an economy:

(i) Inheritance:

Some persons are born with a silver spoon. Rich inheritance gives them a start in life and if they are reasonably prudent, they keep up the lead. Some persons are born landless; others inherit a few acres and still others thousands of acres. Parents of some persons die penniless or still worse die under debt passing the burden of debt on to their children, while others leave huge cash balances for the benefit of their heirs. So long as the system of inheritance lasts, inequalities are bound to be perpetuated.

(ii) System of Private Property: Under the system of private property, a person is free to earn, free to save and free to own property. Once acquired, property breeds further and there are large accretions thereto almost automatically. If there had been no system of private property, people will altogether lose incentives to work and to save. Property is the very basis or cause of inequality of incomes. First a man earns and acquires property; and then his property starts earning. That is why some earn less and others more. Differences in property lead to differences in incomes.

(iii) Differences in Natural Qualities:

No two persons have the same natural talent. Some are more gifted than others. Persons who are endowed by nature with superior intelligence, better physique and greater capacity for hard work must surpass others in the race of life. Some inherit a feeble mind in a feeble body, and they naturally lag behind.

(iv) Differences in Acquired Talent:

It is true to some extent that environments make the man. Natural or inborn qualities are considerably modified by environments. A child may be born intelligent but if he is not lucky enough to receive proper education, the latent abilities remain undeveloped. On the other hand, a child of mediocre ability, if properly nursed, brought up and educated, will more than make up for the lack of natural gifts.

There is no doubt that if one undergoes technical training of the right type after a course of general education, his efficiency will improve. Commercial education may also improve efficiency and raise a person's income-making capacity. Differences in personal efficiency are thus an important cause of inequality of incomes.

(v) Family Influence:

It is generally recognized that the job that a person gets is very largely determined by the family influence. Ordinary graduates manage to get lucrative jobs through the influence of relations and friends, whereas brilliant graduates without helpful contacts may have to be content with low-paid jobs. That is why unequal incomes are earned by different persons. In this world, family contacts make a lot of difference to what people earn.

(vi) Luck and Opportunity:

Some persons are lucky enough to get a good chance and they may make the most of it. Kennedy's assassination gave a chance to Lyndon Johnson. It sometimes happens that a person comes to know of a vacancy and gets it. A business man happens to start business in a place which turns out to be one of very favourable location.

It is sheer chance. It is well known that under-developed regions do not offer good opportunities for employment, whereas the developed regions have ample opportunities. This is also an important cause of inequality of incomes. These are some of the causes which give rise to inequality of incomes.

Consequences of Inequality:

Inequality of incomes leads to some very serious economic and social consequences:

(a) Class-conflict:

It has created two sections in society—the 'haves' and the 'have-not's—which are ever on the war path. This has resulted in ever mounting social tensions and political discontent.

(b) Political Domination:

The rich dominate the political machinery, and they use it to promote their own exclusive interests. This results in corruption, graft and social injustice.

(c) Exploitation:

The rich exploit the poor. The consciousness of this exploitation leads to political awakening and then agitation and even political revolution. Thus inequality of incomes is an important cause of social and political instability.

(d) Creation of Monopolies:

Unequal incomes promote monopolies. These powerful monopolies and industrial combines charge unfair prices from the consumer? And crush the small producers. The bigger fish swallow the small fry.

(e) Suppression of Talent:

It is said that 'slow rises merit by poverty depressed'. It is not easy for a poor man to make his way in life, however brilliant he may be. It is a great social loss that brainy people without money are unable to make their due contribution to social welfare.

(f) Undemocratic:

Democracy is a farce when there is a wide gulf between the rich and the poor. Political equality is a myth without economic equality.

(g) Moral Degradation:

The rich are corrupted by vice and the poor demoralized by lack of economic strength. Thus inequalities spoil the rich and degrade the poor. Vice and corruption rule such a world. The poor man finds it almost impossible to regain the virtues of honesty and integrity. Human dignity is lost altogether.

(h) Promotes Capital Formation:

However, there is one good which comes out of these inequalities of incomes and that is that it facilitates savings. If the national income of the country is evenly distributed among all its citizens, it is clear that it will be only thinly spread over the whole population. Everyone will have nothing left for saving. It is only when income is unequally distributed that there are people who are so rich that in their case saving is automatic.

It is only a minority of the people who have the saving habit. To the rest if income comes, it is squandered away. Under a system, where there are large accretions of wealth in certain patches, not only is the capacity for savings greater, but the ability to invest and gain is also greater. There are people who save and turn their saving into capital. Thus inequality of incomes helps capital formation in a country.

Measures to Reduce Inequalities:

In the present era of social and political awakening, it has become a major plank of political policy that inequalities of incomes should be reduced, if not eliminated. India also has decided to set up a 'socialistic pattern of society'. With this end in view, the government strives to prevent the concentration of wealth and income in a few hands.

The following are some of the measures which can be suggested to reduce inequality of incomes:

(i) Fixing Minimum Wage:

One step that can be taken in the direction of more egalitarian society is to guarantee each citizen a minimum wage consistent with a minimum standard of living. In India in 1948, the Minimum Wages Act was passed in pursuance of which minimum wages are being fixed for agricultural labour and labour in what are called the 'sweated trades'. This is a step which will level up the incomes from below.

(ii) Social Security:

Another important measure is the introduction of a comprehensive social security scheme guaranteeing to each individual a minimum standard of economic welfare. The social security scheme that we envisage must include provision of free education, free medical and maternity aid, old-age pension, liberal unemployment benefits, sickness and accident compensation, provident fund and schemes of social insurance, etc. In that manner, substantial benefits can be

assured to persons whose incomes are low. Such benefits of course have a money value. This will be another step towards leveling up incomes.

Social services like public parks, libraries, museums, community air-conditioned halls, community radio and TV sets, refrigerators may be provided on a liberal scale, so that the poor are able to enjoy almost all possible amenities available to the rich.

(iii) Equality of Opportunity:

The Government may devise and set up some sort of machinery which may provide equal opportunities to all rich and poor in getting employment or getting a start in trade and industry. In other words, something may be done to eliminate the family influence in the matter of choice of a profession. For example, the government may institute a system of liberal stipends and scholarships, so that even the poorest in the land can acquire the highest education and technical skill.

The recruitment to all jobs may be made by an impartial Selection Board or Public Services Commission. Recruitment even in the private sector may be done by employment exchanges or independent selection agencies. In the same manner, to give start in trade and industry, the Government may give financial aid or loans at very reasonable rates repayable in easy installments to all those who wish to enter trade and industry.

In India, several concessions are being offered to scheduled castes and backward classes or persons living in backward areas so that the evils of their backwardness may be minimized. Lot has been done under the 20-Point Economic Programme to help the poor and lift them economically, such as abolition of bonded labour, scaling down or writing off of debts, provision of house sites, etc.

(iv) Steeply-graded Income Tax:

Mere leveling up will not bridge the gulf between the rich and the poor. It will also be necessary to raze to the ground the high mountains of privilege. For this purpose all possible fiscal devices should be adopted. One such device is the steeply progressive taxes on incomes. This will prevent, to some extent, a rich man from getting richer still. Other direct taxes like the super tax, excess profits tax, and capital gains tax and limitation of dividends, etc., may also be imposed.

(v) High Taxes on Luxuries:

All conspicuous consumption by the rich may be ruthlessly crushed by means of heavy taxation of the consumption of luxuries by them. This will take away from the rich the power to display their wealth. This will also take away the incentive to amassing wealth for exclusive private enjoyment. Expenditure tax in India sought the same objective. (This tax has, however, been abolished.)

(vi) Steep Succession Taxes and Estate Duty and Wealth lax:

Lest inequities should be perpetuated from generation to generation, steeply-graded estate duty and/or wealth tax may be imposed. In 1964-65 and again in 1966-6, rate of estate duty were made steeper in India. They want up to 40%, which is almost expropriator. (However in the Finance Act of 1985 the Estate duty was abolished and wealth tax rates were also reduced.)

(vii) Ceilings on Agricultural Holdings and Urban Property:

With a view the reducing inequalities between the big and small farmers, ceilings on agricultural land holdings can be imposed. This has been done in India and recently the ceilings have been to lowered to 10-18 standard acres. The main purpose of land ceilings is to bring about a wider and equal ownership and use of land.

As a counterpart, a ceiling on urban property can be imposed so that inequalities in urban areas can also be toned down. More radical socioeconomic reforms seem to be in the offing in India. These are some of the measures that can be adopted to reduce inequalities. But inequalities can be reduced, they cannot be eliminated altogether. In fact, absolute equality is unattainable.

D. Debate on State vs. Market

The economy of the country is influenced by the policies of the government. These policies, in turn, are determined by the political ideologies of the parties in power. Thus a socialist or communist regime would traditionally like to control the factors of production and ensure that economy is centrally planned. On the other hand, a true capitalist or laissez faire regime would not interfere with production and distribution but would expect the market to determine such issues. In today's world, such ideological polarisation is hard to find.

The Great Depression in USA had led the country to liberalise, privatise and globalise their economy. Fall of the Soviet Union (socialist state) has given a false notion for other countries to follow the West. Communist countries like China and Vietnam also embraced the western ideas of economy development. The IMF and WB which was set up to help those countries which have high fiscal deficits by providing low interest loans have become puppets in the hands of the USA. They have been advocating the third world countries to open up their markets to foreign investments and urging the private sector to play a leading role in shaping up the country's economy.

After independence, India's economic policy was more of a state dominated one. Welfare state and nation state was the mantra. Heavy licence quota permit raj prevailed which made it extremely difficult for private industries to be established and inflow of foreign capital. The burden on the state to satisfy every individuals needs increased. Welfare schemes and subsidies also increased. Government felt shortage of funds due to growing expenses and hence ended up in financial crisis in 1991. This situation led India to adopt the policy of liberalisation, privatisation and globalisation. Though aftermath of LPG, India did see a growth in the economy

and did make many milliners it also witnessed the conditions of the weaker and poorer sections of the society become worse. Hence the increase in the economic growth was a false notion. It was not an inclusive growth. Private companies focussed only on profits and not on the greatest happiness of the greatest numbers. This led to increase in corruption and black money. Hence giving monopoly to the market was not a wise option.

Giving total monopoly to the state has its own drawbacks. It makes the economy too rigid by applying unnecessary rules on private and foreign investment. The state sponsored industrialisation is a cumbersome process having to get many permits and licences. Public sector industries began to make losses. They had unruly labour and inefficient managements. We cannot become spendthrift by just throwing away money on so called welfare projects without enough social audit to find out whether what we are spending really goes to the poor. Rajiv Gandhi estimated that hardly 15 percent reached the people to whom they were intended. Too much of Socialism is bad. What we need is neither an omnipotent State nor total Liberalization. There should be enough regulations to see that private enterprise does not take the country for a ride. Nor should the State control all aspects of economy. The argument is no longer state versus market, but state and market together.

E. Inclusive Growth

Inclusive growth is a concept that advances equitable opportunities for economic participants during economic growth with benefits incurred by every section of society.

The definition of inclusive growth implies direct links between the macroeconomic and microeconomic determinants of the economy and economic growth. The microeconomic dimension captures the importance of structural transformation for economic diversification and competition, while the macro dimension refers to changes in economic aggregates such as the country's gross national product (GNP) or gross domestic product (GDP), total factor productivity, and aggregate factor inputs.

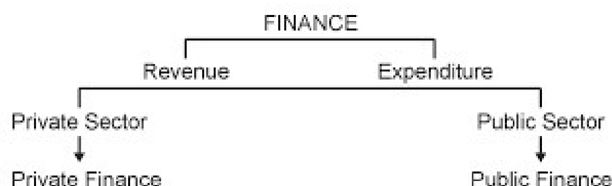
Inclusion is one of the most important words spoken with regard to diversity. But the most frequent spoken word among them could be inclusive growth. Inclusive growth basically means making sure everyone is included in growth, regardless of their economic class, gender, sex, disability and religion. Inclusive growth approach takes on long term perspective and the focus is on productive employment rather than merely direct income redistribution as a means of increasing income for excluded groups. Thus inclusive growth approach took a long term perspective of development. According to World Bank, the growth said to be inclusive when the growth to be sustainable in long run and it should be broad based across the sector and inclusive of large part of countries labour force. Inclusiveness should understand in the sense and focusing on equality of opportunity in terms access to markets, resources and unbiased regulatory environment for business and individual.

Sustainable economic growth requires inclusive growth. Maintaining this is sometimes difficult because economic growth may give rise to negative externalities, such as a rise in corruption,

which is a major problem in developing countries. Nonetheless, an emphasis on inclusiveness—especially on equality of opportunity in terms of access to markets, resources, and an unbiased regulatory environment—is an essential ingredient of successful growth. The inclusive growth approach takes a longer-term perspective, as the focus is on productive employment as a means of increasing the incomes of poor and excluded groups and raising their standards of living.

Unit-III: Public Finance

A. Concept of Public Finance and Private



Meanings:

public finance is a branch of economics that deals with the expenses and revenues from government to government in the economy.

The long-term financing is revenue and expenditure. If you have a link to the private sector, private financing is needed. On the other hand, if it related to the public sector, ie, the public finances.

Private Finance:
Deal to income and expenditure by the private sector.

Public Finance:
This revenue and expenditure of the Government Sector (public sector)

Public finance Vs Private finance
1. Time period: The public finances in a period of several years together, while private financing to do with the financial daily, weekly, monthly, etc.

2. Assets Vs expenditure: In public finance, income from fees as follows. In addition, the cost of private financing in line with sales.

3. Arrears financing: Budget deficit, government. can create new tickets issued. In addition, the private sector has no authority to issue new tickets.

4. Nature of budget: In the public sector's budget deficit is important. In the private sector, the budget surplus is large.

5. Compulsory loans: The government can borrow to bind to other financial institutions to their cost, while the private sector can not be met.

6. Secrecy: State budget is not a secret, but Govt. published their budgets for television, radio, etc. On the other hand, the household, to keep the secret.

7. Nature of projects: In public finance, the government must complete the long-term projects. In addition, the private sector has a short project is completed.

B Tax System: Meaning and Classification

What is Tax?
A tax is a compulsory payment levied on the persons or companies to meet the expenditure incurred on conferring common benefits upon the people of a country.

Two aspects of taxes follow from this definition:
(1) A tax is a compulsory payment and no one can refuse to-pay it.

(2) Proceeds from taxes are used for common benefits or general purposes of the State. In other words, there is no direct quid pro quo involved in the payment of a tax.

This implies that an individual cannot expect or demand that the Government should render him a specific service in return for the tax paid by him. However, this does not imply that Government does nothing for the people from whom it receives taxes.

In fact Government spends the tax money for the general or common benefits of all the people rather than conferring any special benefit on a particular tax payer. To quote Taussig, "The essence of a tax, as distinguished from the other charges by Government is the absence of any direct quid pro quo between the tax payer and the public authority."

Tax should be carefully distinguished from a fee. Fee is also compulsory payment made by a person who receives in return a particular benefit or service from the Government. For paying fee on a television or radio, a person gets the benefits of programmes relayed by the Government on television or radio. Likewise, students who pay the education fee in schools and colleges, obtain the benefits of teaching arranged by the Government.

The amount of fee is always less than the cost of service rendered by the Government in return and therefore covers only a part of the cost of service rendered. Thus, even in case of fee, there is a general public interest or common benefit of the service rendered by the Government. In this case, the Government undertakes a service for the common benefits of the citizens and obtains a fee from those who avail of that service to cover a part of the cost of service rendered.

Classification of Taxes:

The taxes have been variously classified. Taxes can be direct or indirect, they can be progressive, proportional or regressive, and indirect taxes can be specific or ad-valorem. We spell out below the meanings of these different types of taxes.

Direct and Indirect Taxes:

The distinction between direct and indirect taxes is based on whether or not the burden of a tax can be shifted wholly or partly to others. If a tax is such that its burden cannot be shifted to others and the person who pays it to the Government has also to bear it, it is called a direct tax. Income tax, annual wealth tax, capital gains tax are examples of direct taxes. In case of a direct tax there is a direct contact between the tax payer and tax levying public authority.

On the other hand, indirect taxes are those whose burden can be shifted to others so that those who pay these taxes to the Government do not bear the whole burden but pass it on wholly or partly to others. For instance, excise duty on the production of sugar is an indirect tax because the manufactures of sugar include the excise duty in the price and pass it on to buyers. Ultimately, it is the consumers on whom the incidence of excise duty on sugar falls as they will pay higher price for sugar than before the imposition of the tax.

Thus, though excise duties are on the production of commodities but they can be shifted to the consumers. Likewise, sales tax on commodities can also be passed on to buyers or consumers in the form of higher prices charged for the commodities.

Therefore, excise duties and sales taxes on commodities are examples of indirect taxes. They are also known as commodity taxes. In the case of indirect taxes, there is an indirect relation, between the Government and those who ultimately bear the burden of the taxes.

Specific and Ad-Valorem Taxes:

Indirect taxes can be either specific or ad-valorem. A specific tax on a commodity is a tax per unit of the commodity, whatever its price. Thus the amount of total specific tax will vary in accordance with the changes in total output or sales of the commodity and not with the total value of output or sales.

On the other hand, an ad-valorem type of an indirect tax is levied according to the value of the commodity. For instance, sales tax in India is an ad-valorem tax as the rate of sales tax in case of several commodities is 10 per cent of the value of sales of the commodities. Ad-valorem taxes are progressive in their burden on consumers whereas specific taxes are regressive.

Progressive, Proportional and Regressive Taxes:

According to another classification, taxes can be progressive, proportional or regressive. In case of proportional tax, the same rate of the tax is charged, whatever be the magnitude of the base on which it is levied. For instance, if rate of income tax is 25 per cent whatever the size of income of a person, it will then be a proportional income tax. Likewise, if rate of wealth tax is 5 per cent, it will be proportional wealth tax.

Thus, in case of proportional tax it is the rate which is fixed and not the absolute amount of the tax. Thus with the rate of 25 per cent proportional income tax, a person with income of Rs. 25,000 will pay Rs. 6,250 as the tax, and a person with income of 50,000 will pay Rs. 12,500 as the tax. Thus, even under proportional income tax, a richer person has to pay greater amount of tax though rate of the tax is the same.

On the other hand, in case of a progressive tax, rate of the tax increases as the amount of the tax base (income, wealth or any other object) increases. The principle underlying a progressive tax is that greater the tax base, the higher the tax rate. In India income tax, an important direct tax levied by the Central Government, is progressive.

Its rate at present (1998-99) varies from 10 per cent in the slab of Rs. 40,000 to 60,000 to 30 per cent in the slab of income above Rs. 1,50,000. Under progressive income tax, the richer person pays not only absolutely more tax but also a higher rate of the tax. Thus, the burden of progressive tax falls more heavily on the richer persons as compared to proportional income tax.

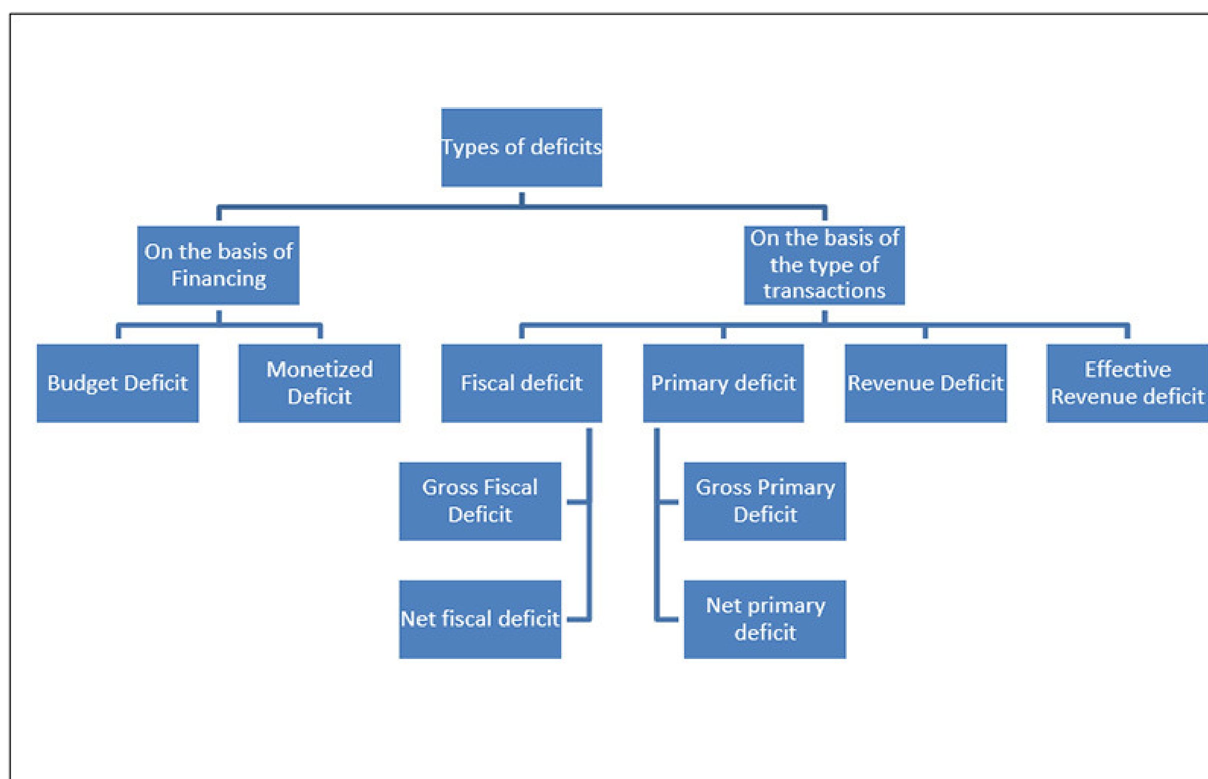
A regressive tax is the opposite of a progressive tax. In case of a regressive income tax, the rate is lowered as the income rises. Thus, under regressive tax system, the burden of the tax is relatively more on the poor than on the rich. A regressive tax is therefore inequitable and no civilised Government in the world today will levy such a tax.

C. Burden of Deficit and Debts

There are different measures of deficits in macroeconomics and each type of deficit measure carries a different macroeconomic meaning. The broad measures of deficit (which have been

and/or are being) reported by the government in India, may be classified, either in terms of the '*nature of transactions*' or on the basis of the '*means of financing*' them.

The chart below elucidates a list of different types of deficits that have been and are being used in India.



I. Meaning of different measures of deficit

(a) Fiscal Deficit Gross Fiscal Deficit is defined as the excess of total expenditure of the government over the total non-debt creating receipts.

Fiscal deficit can be either 'gross' or 'net'. The Central government makes capital disbursements as loans to the different segments of the economy. In the developing countries, a large part goes as loans to other sectors-States and local Governments, public sector enterprises and the like. Net fiscal deficit can be arrived at by deducting net domestic lending from gross fiscal deficit .

(b) Budget Deficit Also referred to as simply 'budget deficit' is that part of the government's deficit which is financed through short-term borrowings. These short-term borrowings may be from the RBI or from other sources.

Normally, short-term borrowings from the RBI are through the net issuance of short-term treasury bills (that is, ad-hoc and ordinary[2] treasury bills) and by running-down the central government's cash balances held by the RBI.

(c) Monetized deficit Also known as the 'net reserve bank credit to the government', it is that part of the government deficit which is financed solely by borrowing from the RBI.

Since borrowings from the RBI can be both short-term and long-term, therefore, monetized deficit is the sum of the net issuance of short-term treasury bills, dated securities (that is, long-term borrowing from the RBI) and rupee coins held exclusively by the RBI, net of Government's deposits with the RBI.

This is different from the Traditional Budget deficit in two ways-

1. Traditional Budget deficit includes 91-day treasury bills held by both, the RBI and non-RBI entities whereas Monetized deficit includes 91-day Treasury Bills held only by the RBI.
2. Traditional Budget deficit includes only short-term sources of finance whereas Monetized deficit includes long-term securities also.

<table>
<tr><th>Term of Financing</th><th>Types of Financing</th><th colspan="3">Types of Deficits</th></tr>
<tr><td rowspan="2">Long term financing (a+b)</td><td>a) Long-term financing other than RBI</td><td></td><td rowspan="2"></td><td rowspan="5">Gross Fiscal deficit (a+b+c+d+e)</td></tr>
<tr><td>b) Long-term financing from RBI</td><td rowspan="2">Monetized deficit (b+c)</td></tr>
<tr><td rowspan="3">Short term financing (c+d+e)</td><td>c) Short-term financing from RBI</td><td rowspan="3">Traditional budget deficit (c+d+e)</td></tr>
<tr><td>d) Short-term financing from other than RBI</td><td rowspan="2"></td></tr>
<tr><td>e) Draw down of cash</td></tr>
</table>

(d) Primary Deficit Gross Primary deficit is defined as gross fiscal deficit *minus* net interest payments. Net primary deficit, is gross primary deficit minus net domestic lending.

(e) Revenue deficit Revenue deficit is defined as the difference between revenue expenditure and revenue receipts.

(f) Effective revenue Deficit Introduced in 2011-12, it is defined as revenue deficit minus that revenue expenditure (in the form of grants), which goes into the creation of Capital Assets

<table>
<tr><td>(a) Net Interest Payment</td><td colspan="4"></td><td rowspan="4">Net Fiscal Deficit (a+b+c+d)</td><td rowspan="5">Gross Fiscal Deficit (a+b+c+d+e)</td></tr>
<tr><td>(b) Revenue expenditure (excluding revenue expenditure for creation of capital assets) minus revenue receipts</td><td rowspan="3">Net Primary Deficit (b+c+d)</td><td rowspan="4">Gross Primary Deficit (b+c+d+e)</td><td>Effective Revenue deficit (b)</td><td rowspan="2">Revenue Deficit (b+c)</td></tr>
<tr><td>(c) Revenue Expenditure for creation of capital assets</td><td rowspan="3"></td></tr>
<tr><td>(d)Net non-debt creating capital expenditure</td><td rowspan="2"></td></tr>
<tr><td>(e) Net domestic lending</td><td></td><td></td></tr>
</table>

(g) Other measures of deficit Apart from these, there are various other types of measures of deficit that are widely used internationally, like the **Consolidated Public Sector Deficit**, which is the excess of expenditure over revenue for all the government entities; **Operational Deficit**, which is the 'inflation-corrected' deficit and is defined as Consolidated Public Sector Deficit minus inflation rate times the debt stock; **Structural deficit** which removes the effects of temporary movements in the variables from their long-run values, thereby providing an idea of the long-run position of the country after removing the impact of temporary shocks; and others.

II. Significance of different measures of deficit

S.No	Deficit Measure	Significance
1	Fiscal Deficit	Widely used as a summary indicator of the macroeconomic impact of the budget in several industrialized countries. This measure has been adopted by the IMF as the principal policy target in their programmes. In India, the government began to report the fiscal deficit only after 1991.
		Since the shortfall in receipts over expenditure must be covered through borrowing, therefore, Gross Fiscal Deficit, gives the overall borrowing requirements of the government over a given financial year. And thus shows the net addition to

		the level of public debt during a financial year.
2	Budget Deficit	In the presence of the system of automatic monetization of deficits through issuance of ad-hoc treasury bills, this measure of deficit, becomes an important target to keep in check. However, in the year 1997, the government discontinued the issuance of ad-hoc and tap treasury bills. As a result of this, now, the concept of budget deficit in the traditional sense has lost its significance in public finance and is now not reported in the Budget documents of the Government of India.
3	Monetized Deficits	Monetization of deficits, which increases the money supply, is inflationary if the rate of growth of money supply is greater than the rate of increase of the demand for cash balances arising from the growth of the economy. Thus, monetized deficits are an important indicator of the inflationary impact of the increase in government's budgetary deficits.
4	Primary Deficits	It excludes the burden of the past debt and shows the net increase in the government's indebtedness due to the current year's fiscal operations. A reduction in primary deficit is reflective of government's efforts at bridging the fiscal gap during a financial year.
5	Revenue Deficit	A positive revenue deficit implies that the government is resorting to borrowing to finance current consumption.

D. Fiscal Policy: Concept, Objective and Instruments

fiscal policy is the use of government revenue collection (mainly taxes) and expenditure (spending) to influence the economy. According to Keynesian economics, when the government changes the levels of taxation and governments spending, it influences aggregate demand and the level of economic activity. Fiscal policy can be used to stabilize the economy over the course of the business cycle.[2]

The two main instruments of fiscal policy are changes in the level and composition of taxation and government spending in various sectors. These changes can affect the following macroeconomic variables, amongst others, in an economy:

- Aggregate demand and the level of economic activity;
- Savings and Investment in the economy
- The distribution of income

Fiscal policy can be distinguished from monetary policy, in that fiscal policy deals with taxation and government spending and is often administered by an executive under laws of a legislature, whereas monetary policy deals with the money supply, lending rates and interest rates and is often administered by a central bank.

Some of the essential objectives of fiscal policy are: 1. Fiscal Policy for Full Employment, 2. Economic Stabilization, 3. Economic Growth, 4. Social Justice!

1. Fiscal Policy for Full Employment:

Keynes regarded public finance as compensatory finance ordained to attain and maintain full employment in the economy.

To pursue this goal, Keynes suggested that:

(i) Taxation should be devised to promote and sustain consumption and investment.

(ii) To raise the level of effective demand and to overcome depressionary forces, budget should be in deficit and it should have deficit financing.

(iii) Public expenditure has to be compensatory one. It has to be in a planned way to finance public works programmes and provide social security measures.

(iv) Direct taxes should be lowered to encourage savings and investments directed towards creation of more employment opportunities.

(v) Public expenditure should be meant for uplifting the level of aggregate demand, investment and employment.

(vi) Public borrowings should be on a large scale to finance productive public expenditure.

Once full employment level is reached, it has to be constantly maintained by adopting appropriate fiscal measures from time to time.

In a developing economy, fiscal policy has also to solve the problem of disguised unemployment. Hence, public works programmes have to be undertaken at village level to provide alternative employment opportunities.

2. Fiscal Policy and Economic Stabilisation:

Economic stability is another prime aim of a sound fiscal policy. This goal implies maintenance of full employment with relative price stabilisation. Price stability here means relative price stability. Inflation should be curbed and deflation should be avoided.

In short, economic growth and stability are the twin objectives jointly pursued by a developing country's fiscal policy. The forces stimulating growth process should be given a boost at a time while inflationary pressures are to be curbed.

In a growing economy, when huge investment is undertaken to construct social overhead capital, infrastructure of the economy and development of heavy industries, on account of long gestation period, returns are not immediate, as scarcity of consumption goods is felt. This leads to a rising price spiral. A demand-pull inflation thereby causes wages etc. to go up and a cost-push inflation is provoked. The vicious circle of inflation has to be checked through appropriate fiscal measures.

3. Fiscal Policy and Economic Growth:

Poor countries are entangled in the vicious circle of poverty. It should be broken. Thus, rapid economic growth is the fundamental objective of fiscal policy in a developing economy.

Fiscal policy as a means of encouraging growth process has the following objectives:

1. To realise and mobilise potential resources into the productive channels. For this fiscal policy should aim at improving marginal propensity to save and the consequent incremental saving ratio.

The following methods have been suggested by Prof. Tripathy for raising the incremental saving ratio:

(i) Imposition of additional taxes.

(ii) Direct physical control.

(iii) Revenue of public enterprises.

(iv) Increase in the rates of taxation.

(v) Public debt.

(vi) Deficit financing.

2. To accelerate the rate of economic growth. In this regard, fiscal measure must be conducive to growth process. In no way should fiscal mean adversely affect the ability and willingness to work hard, save more and invest.

3. To induce and stimulate private sector investment.

4. To promote investment into socially desirable channels.

5. To alter the pattern of investment and production in such a way as to improve the general economic welfare and sustain egalitarian goals like equity in distribution and eradication of poverty.

4. Fiscal Policy and Social Justice:

A welfare state should provide social justice by giving equitable distribution of income and wealth. Fiscal policy can serve as an effective means of achieving this much desired goal of socialism in developed as well as developing countries. Progressive tax system can be of much use in realising this objective. Moreover, public expenditure helps in redistributing income from the rich to the poor section of the society.

E. Central Budget

Meaning of Union (Central) Budget of India:

According to Constitution of India, there is three-tier system of government, namely. Central (or Union) government.

State government and Local government (like Municipal Corporation, Municipal Committee, Zila Parishad, etc.). Accordingly, these governments prepare their own respective budgets (called Union Budget, State Budget and Municipal Budget) containing estimates of expected revenue and proposed expenditure.
The basic structure of government budget is almost the same at all levels of government but items of expenditure and sources of revenue differ from budget to budget. Again, there is no clash with regard to sources of revenue because functions of Central, State and local government have been clearly demarcated and laid down in the Indian Constitution. However, we shall discuss here the budget of the Central Government.
Central Government is constitutionally required to lay an "annual financial statement" before both the houses of Parliament. This statement is conventionally called Government Budget. Accordingly, in India, every year Central (or Union) Budget for the coming financial year is presented by the Union Finance Minister in the Lok Sabha normally on the last working day of the month of February.
It gives item wise details of government receipts and expenditure for three consecutive years, i.e., Actuals for the preceding year. Budget estimates for the current year. Revised estimates for the current year and Budget estimates for the ensuing (coming) year .For Instance, Union Budget for the financial year 2015-2016 as presented in the Parliament reflects this approach.
It contains details of government Receipts and Expenditure under the following four heads:

(i) Actual Budget estimates for the year 2015-16

(iii) Revised estimates for the year 2015-16

(iv) Budget estimates for the year 2016-17

Components of the Union (Central) Budget of India:

The budget is divided into two parts:

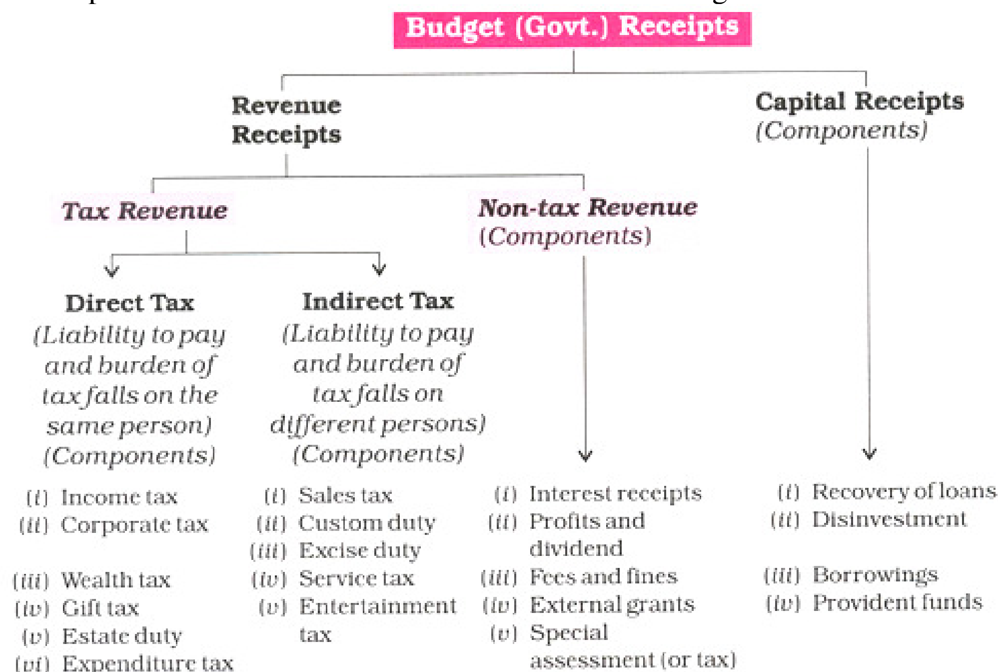
(i) Revenue Budget and

(ii) Capital Budget.

The Revenue Budget comprises revenue receipts and expenditure met from these revenues. The revenue receipts include both tax revenue (like income tax, excise duty) and non-tax revenue (like interest receipts, profits). Capital Budget consists of capital receipts {like borrowing, disinvestment) and long period capital expenditure (creation of assets, investment).

Capital receipts are receipts of the government which create liabilities or reduce financial assets, e.g., market borrowing, recovery of loan, etc. Capital expenditure is the expenditure of the government which either creates assets or reduces liability. Capital budget is an account of assets and liabilities of the government which takes into consideration changes in capital.

Structure or components of a government budget broadly consists of two parts—Budget Receipts and Budget Expenditure as shown in the following chart with their



classification.

Unit-IV:

Liberalization, Globalization and Related Issues

A. New Economic Policy: Structural Adjustment Programme (SAP)

Structural adjustment programmes (**SAPs**) consist of loans provided by the International Monetary Fund (IMF) and the World Bank (WB) to countries that experienced economic crises. The two Bretton Woods Institutions require borrowing countries to implement certain policies in order to obtain new loans (or lower interest rates on existing ones). The conditionality clauses attached to the loans have been criticized because of their effects on the social sector.

SAPs are created with the goal of reducing the borrowing country's fiscal imbalances in the short and medium term or in order to adjust the economy to long-term growth. The bank from which a borrowing country receives its loan depends upon the type of necessity. The IMF usually implements stabilization policies and the WB is in charge of adjustment measures.

SAPs are supposed to allow the economies of the developing countries to become more market oriented. This then forces them to concentrate more on trade and production so it can boost their economy. Through conditions, SAPs generally implement "free market" programmes and policy. These programs include internal changes (notably privatization and deregulation) as well as external ones, especially the reduction of trade barriers. Countries that fail to enact these programmes may be subject to severe fiscal discipline. Critics argue that the financial threats to poor countries amount to blackmail, and that poor nations have no choice but to comply

Since the late 1990s, some proponents of structural adjustment, such as the World Bank, have spoken of "poverty reduction" as a goal. SAPs were often criticized for implementing generic free-market policy and for their lack of involvement from the borrowing country. To increase the borrowing country's involvement, developing countries are now encouraged to draw up Poverty Reduction Strategy Papers (PRSPs), which essentially take the place of SAPs. Some believe that the increase of the local government's participation in creating the policy will lead to greater ownership of the loan programs and thus better fiscal policy. The content of PRSPs has turned out to be similar to the original content of bank-authored SAPs. Critics argue that the similarities show that the banks and the countries that fund them are still overly involved in the policy-making process. Within the IMF, the Enhanced Structural Adjustment Facility was succeeded by

the Poverty Reduction and Growth Facility, which is in turn succeeded by the Extended Credit Facility

B. Free Trade and Protection

A trade policy of placing no restrictions on the movement of goods between countries is known as the policy of 'Free Trade.' Such a policy permits the flow of international commerce in its natural environment, free of artificial impediments.

According to Adam Smith, the term 'free trade' is used to denote 'that system of commercial policy which draws no distinction between domestic and foreign commodities and, therefore, neither imposes additional burdens on the latter, nor grants any special favour to the former.' In other words, free trade implies complete freedom of international exchange. Under such policy, there are no barriers to the movement of goods between countries and exchange can take its perfectly natural course.

The policy of free trade, however, does not require the removal of all sorts of duties on commodities in international exchange. It insists that duties may be imposed exclusively for revenue and not at all for protection.

Classical economists like Adam Smith, Ricardo etc., were enamoured of the policy of free trade, as a reaction against mercantilism dominating England and other continental countries in the sixteenth and seventeenth centuries. They argued that free trade was economically advantageous on the following counts:

1. It permits an allocation of resources and manpower in accordance with the principle of comparative advantage, which is just an extension of the principle of division of labour. Because of natural and other facilities, each country is suited for the production of some particular commodities.

When countries are freely engaged in trade, the price mechanism under competition automatically ensures that each country specialises in producing those commodities which it is relatively best suited to produce and imports those commodities which it can obtain more cheaply than by producing them itself. Further, when there is specialisation, the labour and capital of a country tend to move into those channels of industry where they have optimum use and can produce maximum.

Thus, the production of goods cart be enormously increased by an international division of labour rendered possible by free trade. Such territorial specialisation brings gain to all concerned and maximises national products, when there is free 'international trade. Classicists, therefore,

argued that any obstacle to free transactions of goods between countries curtails the possibilities of specialisation and to that extent reduces the national product.

Ellsworth hence, writes: "Therefore, since the income of any community or nation is large just in proportion to the extent to which it specialises, the greatest possible freedom of trade is justified."

In short, according to the classical economists, the gain from free international trade would be the largest due to international specialisation based on comparative advantage. Free trade leads to the most efficient conduct of economic affairs. In a plea for free trade, they also said that even if some countries do not follow the policy of free trade, an industrial country should follow it unilaterally as it will gain thereby.

2. Under free trade, factors of production also will be able to earn more, as they will be employed for better use. Hence, wages, interest and rent will be higher under free trade than otherwise.
3. Free trade procures imports at cheap rate. It seems to be an attractive argument in favour of free trade at least from the consumer's point of view. However, it ignores the question of employment and the interests of producers in the importing country. Here it has been pointed out that under free trade, when consumers gain through lower price, producers also gain as the factors of production are directed to more gainful and specialised production which gives better earnings.
4. Free trade widens the size of the market as a result of which greater specialisation and a more complex division of labour become possible. This brings about optimum production with costs reduced everywhere, benefiting the world as a whole. Restrictions on free trade reduce the scope of specialisation and in consequence there is a reduction of the total world supply, thereby, making the world as a whole so much the poorer economically.
5. Free trade also widens the area of competition as a result of which the industrial techniques of the trading countries tend to be improved. Home producers are spurred by foreign competition to become more efficient and to adopt quickly any improvement in methods of production. In this way free trade has an educative effect.
6. Another incidental advantage of free trade is that it prevents, or at least makes more difficult, the establishment of injurious monopolies by preserving competition.

Experience, however, shows that free trade cannot provide a complete safeguard against the formation of monopolies; international as well as local. The local monopolies owe their existence to transport costs involved in international exchange.

Despite the clamour of the classical economists about the advantages of free trade, the policy has either not been adopted by many countries or abandoned by those who already adopted it.

Economic history indicates that since the last two centuries, international trade has developed with the protection policy.

Free trade policy has been abandoned by all countries for the following reasons:

1. Under the system of free trade, the underdeveloped countries suffer very much in competition with the advanced countries. Free trade, policy in India adopted by the British Government has proved that, the one-time flourishing industries (handicrafts) of India were completely wiped out due to foreign competition. On the continent of Europe also, the people knew the dangers of free trade, and they hastened to erect strong tariff walls to protect their industries.
2. On account of economic interdependence in implementing free trade policy, many governments experienced political handicaps, especially during war times. Hence, for maintaining political independence, it was thought desirable to seek economic independence with the abandonment of free trade.
3. Countries cannot allow free import of injurious and harmful products; hence, trade restrictions become necessary.
4. Free trade led to cut-throat competition in the world market, so that, exporters resorted to dumping, which no government can allow beyond a limit; thus, restrictions became inevitable.
5. Free entry of goods produced by powerful combines inflicts a permanent injury on the economic interests of a country. Hence, restrictions on such items were thought inevitable.
6. Backward countries have to protect their infant industries and hence, cannot adopt the policy of free trade.

Thus, though, in theory free trade looked better, in practice protection got the upper hand.

Protection :

Protection refers to the foreign trade policy of encouraging home industries by paying bounties (or giving subsidies) to domestic producers, or more usually by imposing customs duties on foreign products.

The term protection usually carries in a very loose sense the connotation of a tariff on imports; but it may refer to any policy that raises the price of import substitutes and safeguards the interest of domestic producers against foreign competition.

Tariff system, i.e., customs duties, is an important and most common method of protection. By tariff barriers we mean only those taxes which are intended to restrict international trade.

Protection is an established creed of modern trade policy. Yet it remains to be examined whether, protection is a healthy policy leading to an economic millenium or a policy abounding in hidden dangers.

C. International Institutions: IMF, WB and WTO

The World Bank

The economies of the world are all at different stages of development. Some countries, such as the United States and Western European countries, have highly developed economies that have created a great amount of wealth for its citizens. Other countries, such as the countries of sub-Saharan Africa, are quite underdeveloped compared to the U.S. and large parts of their populations live in poverty.

The World Bank was initially created to help with economic development. It was originally formed shortly after World War II in an effort to rebuild the economies of war-torn countries, but its mission is now global in scope. The general mission of the World Bank is to provide long-term financing for economic development.

The World Bank is actually comprised of two institutions. The **International Bank for Reconstruction and Development (IBRD)**, which provides low-interest and no-interest loans to developing countries who cannot get financing elsewhere. The IBRD also provides technical and research assistance to developing countries. Examples of projects funded by these loans include infrastructure projects, such as power plants, roads, railroads, ports, telecommunication, and water systems. Loans have also been provided for health, education, and debt relief. As you can probably see, these types of projects are foundational for further economic development. For example, if you don't have a healthy, educated population with access to roads, power, safe water, and communications, you will not have significant economic development.

The IBRD has about 188 member nations, which is pretty close to every nation on the planet. A country must pay a subscription to join. Each member country gets 250 votes and can get more votes by buying shares of the IBRD at $100,000 per share. Decisions are made by majority vote, but the largest shareholders can control the outcome because they have most of the votes. The U.S. is the largest shareholder.

The other part of the World Bank is the International Development Association, or IDA. The IDA was started in 1960. It works with the IBRD and focuses its efforts on the poorest countries in the world and offers assistance in turning their struggling economies around.

What does the World Bank do?

The World Bank is the world's largest source of development assistance, providing nearly $30 billion in loans, annually, to its client countries. The Bank uses its financial resources, its highly trained staff and its extensive knowledge base to individually help each developing country onto a path of stable, sustainable and equitable growth. The main focus is on helping the poorest people and the poorest countries hut for all its clients, the Bank emphasises the need for:

investing in people, particularly through basic health and education; protecting the environment; supporting and encouraging private business development; strengthening the ability of the governments to deliver quality services efficiently and transparently; promoting reforms to create a stable macroeconomic environment conducive to investment and long-term planning; focusing on social development, inclusion, governance and institution building as key elements of poverty reduction. The Bank is also helping countries to strengthen and sustain the fundamental conditions that help to attract and retain private investment. With Bank support- both lending and advice- governments are reforming their overall economies and strengthening banking systems. They are investing in human resources, infrastructure and environmental protection which enhance the attractiveness and productivity of private investment. Through World Bank guarantees, MICA's political risk insurance and in partnership with IFC's equity investments, investors are minimizing their risks and finding the comfort to invest in developing countries and countries undergoing transition to market-based economies.

Where does the World Bank get its money?

The World Bank raises money for its development programmes by tapping the world's capital markets and in the case of the IDA, through contributions from wealthier member governments. IBRD, which accounts for about three-fourths of the Bank's annual lending, raises almost all its money in financial markets. One of the world's most prudent and conservatively managed financial institutions, the IBRD sells AAA-rated bonds and other debt securities to pension funds, insurance companies, corporations, other banks and individuals around the globe. IBRD charges interest from its borrowers at rates, which reflect its cost of borrowing. Loans must be repaid in 15 to 20 years; there is a three to five year grace period before repayment of principal begins. IDA helps to promote growth and reduce poverty in the same ways as does the IBRD but using interest free loans (which are known as IDA "credits"), technical assistance and policy advice. IDA credits account for about one-fourth of all Bank lendings. Borrowers pay a fee of less than 1 per cent of the loan to cover administrative costs. Repayment is required in 35 to 40 years with a 10 years grace period. Nearly 40 countries contribute to IDA's funding, which is replenished every three years. IDA's funding is managed in the same prudent, conservative and cautious way as is the IBRD's. Like the IBRD, there has never been default on an IDA credit.

Who runs the World Bank?

The World Bank is owned by more than 180 member countries whose views and interests are represented by a board of governors and a Washington based board of directors. Member countries are shareholders who carry ultimate decision making power in the World Bank. Each member nation appoints a governor and an alternate governor to carry out these responsibilities. The governors, who are usually officials such as ministers of finance or planning, meet at the Bank's annual meetings each fall. They decide on key Bank policy issues, admit or suspend country members, decide on changes in the authorised capital stock, determine the distribution of the IBRD's net income and endorse financial statements and budgets.

World Bank Group

The World Bank Group consists of the IBRD, IDA and three other institutions. The International Finance Corporation, or IFC, helps high-risk business sectors and high-risk countries obtain private sector investors. The Multinational Investment Guarantee Agency, or MIGA, offers

political risk insurance to investors and lenders to encourage investment in developing countries. Finally, the International Centre for Settlement of Investment Disputes, or ICSID, settles disputes between foreign investors and developing countries taking the investment funds.

International Monetary Fund

The International Monetary Fund, commonly referred to as the IMF was created in 1944 and currently has about 188 member countries. One goal of the IMF is to promote international cooperation on international monetary policy. Monetary policy is a country's decision regarding interest rates and money supply. The IMF also tries to encourage the expansion of international trade and promote currency exchange stability. Currency exchange rate stability means that the value of one currency in relation to another is fairly stable.

Finally, the IMF helps countries meet their balance of payment obligations. Balance of payments is the difference in value between imports and exports in a country. A negative balance means there is more money going out of the country than coming in. The IMF can provide short-term financing if a country needs help with a negative balance of payment.

The IMF primarily uses three different tools to accomplish its mission. First, the IMF monitors the economic developments at the global level all the way down to individual nations. It tries to figure out how the monetary and fiscal policies of individual countries affect other countries and their economies. It also analyzes economic trends at all levels - from a global perspective down to a national perspective.

Second, the IMF also provides training and technical assistance in four areas. The IMF offers technical assistance and training regarding monetary and fiscal policies. It also provides training and assistance in fiscal policy and management, including such things as tax and customs policies, budget formulation, designing of social safety nets, and management of debt. Assistance and training is also provided for compiling, managing, and improving statistical data. Finally, the IMF will help with economic and financial legislation.

Origins of IMF

The need for an organisation like the IMF became evident during the great depression that ravaged the world economy in the 1930s. A widespread lack of confidence in paper money led to a spurt in the demand for gold and severe devaluation in the national currencies.

The relation between money and the value of goods became confused as did the relation between the value of one national currency and another. In the 1940s, Harry Dexter (US) and John Maynard Keynes (UK) put forward proposals for a system that would encourage the unrestricted conversion of one currency into another, establish a clear and unequivocal value for each currency and eliminate restrictions and practices such as competitive devaluations. The system required cooperation on a previously unattempted scale by all nations in establishing an. innovative monetary system and an international institution to monitor it. After much negotiations in the difficult war time conditions, the international community accepted the

system and an organisation was formed to supervise it. The IMF began operations in Washington DC in May 1946. It then had 39 members. The IMF's membership now is 182.

Members and administration

On joining the IMF, each member country contributes a certain sum of money called a 'quota subscription', as a sort of credit union deposit. Quotas serve various purposes. They form a pool of money that the IMF can draw from to lend to members in times of financial difficulty.

• They form the basis of determining the Special Drawing Rights (SDR).
• They determine the voting power of the member.

Statutory purposes

The purposes of the International Monetary Fund are:

• To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.
• To facilitate the expansion and balanced growth of international trade and to contribute, thereby, to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
• To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
• To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
• To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive to national or international prosperity.
• In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Financial assistance

The IMF lends money only to member countries with balance of payments problems. A member country with a payments problem can immediately withdraw from the IMF the 25 per cent of its quota. A member in greater difficulty may request for more money from the IMP and can borrow up to three times its quota provided the member country undertakes to initiate a series of reforms and uses the borrowed money effectively. The frequently used mechanisms by the IMF to lend money are

1. Standby Arrangements
2. Extended Arrangements
3. Structural Adjustment Mechanism (With low interest rates)

WTO

The Uruguay round of GATT (1986-93) gave birth to World Trade Organization. The members of GATT singed on an agreement of Uruguay round in April 1994 in Morocco for establishing a new organization named WTO.

It was officially constituted on January 1, 1995 which took the place of GATT as an effective formal, organization. GATT was an informal organization which regulated world trade since 1948.

Contrary to the temporary nature of GATT, WTO is a permanent organization which has been established on the basis of an international treaty approved by participating countries. It achieved the international status like IMF and IBRD, but it is not an agency of the United Nations Organization (UNO).

Structure:

The WTO has nearly 153 members accounting for over 97% of world trade. Around 30 others are negotiating membership. Decisions are made by the entire membership. This is typically by consensus.

A majority vote is also possible but it has never been used in the WTO and was extremely rare under the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top level decision-making body is the Ministerial Conferences which meets at least once in every two years. Below this is the General Council (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Disputes Settlement Body.

At the next level, the Goods Council, Services Council and Intellectual Property (TRIPs) Council report to the General Council. Numerous specialized committees, working groups and working parties deal with the individual agreements and other areas such as, the environment, development, membership applications and regional trade agreements.

Secretariat:

The WTO secretariat, based in Geneva, has around 600 staff and is headed by a Director-General. Its annual budget is roughly 160 million Swiss Francs. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the secretariat does not have the decision making the role that other international bureaucracies are given.

The secretariat s main duties to supply technical support for the various councils and committees and the ministerial conferences, to provide technical assistance for developing countries, to analyze world trade and to explain WTO affairs to the public and media. The secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

Objectives:

The important objectives of WTO are:

1. To improve the standard of living of people in the member countries.

2. To ensure full employment and broad increase in effective demand.

3. To enlarge production and trade of goods.

4. To increase the trade of services.

5. To ensure optimum utilization of world resources.

6. To protect the environment.

7. To accept the concept of sustainable development.

Functions:

The main functions of WTO are discussed below:

1. To implement rules and provisions related to trade policy review mechanism.

2. To provide a platform to member countries to decide future strategies related to trade and tariff.

3. To provide facilities for implementation, administration and operation of multilateral and bilateral agreements of the world trade.

4. To administer the rules and processes related to dispute settlement.

5. To ensure the optimum use of world resources.

6. To assist international organizations such as, IMF and IBRD for establishing coherence in Universal Economic Policy determination.

Table: 2 WTO Ministerial Conference:

Conference	Year	Place
I	9-13 Dec., 1996	Singapore
II	18-20 May 1998	Geneva (Switzerland)
III	30 Nov.-3 Dec., 1999	Seattle (USA)
IV	9-14 Nov., 2001	Doha (Qatar)
V	10-14 Sep., 2003	Cancun (Mexico)
VI	13-18 Dec.. 2005	Hong Kong
VII	30 Nov-2Dec., 2009	Geneva (Switzerland)

WTO Agreements:

The WTO's rule and the agreements are the result of negotiations between the members. The current sets were the outcome to the 1986-93 Uruguay Round negotiations which included a major revision of the original General Agreement on Tariffs and Trade (GATI).

GATT is now the WTO's principal rule-book for trade in goods. The Uruguay Round also created new rules for dealing with trade in services, relevant aspects of intellectual property, dispute settlement and trade policy reviews.

The complete set runs to some 30,000 pages consisting of about 30 agreements and separate commitments (called schedules) made by individual members in specific areas such as, lower customs duty rates and services market-opening.

Through these agreements, WTO members operate a non-discriminatory trading system that spells out their rights and their obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other countries' markets. Each country promises to do the same for imports into its own market. The system also gives developing countries some flexibility in implementing their commitments.

(a) Goods:

It all began with trade in goods. From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important, rules, particularly non-discriminations since 1995, the updated GATT has become the WTO s umbrella agreement for trade in goods.

It has annexes dealing with specific sectors such as, agriculture and textiles and with specific issues such as, state trading, product standards, subsidies and action taken against dumping.

(b) Services:

Banks, insurance firms, telecommunication companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of free and fair that originally only applied to trade in goods.

These principles appear in the new General Agreement on Trade in Services (GATS). WTO members have also made individual commitments under GATS stating which of their services sectors, they are willing to open for foreign competition and how open those markets are.

(c) Intellectual Property:

The WTO's intellectual property agreement amounts to rules for trade and investment in ideas and creativity. The rules state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout designs and undisclosed information such as trade secrets "intellectual property" should be protected when trade is involved.

(d) Dispute Settlement:

The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore, for ensuring that trade flows smoothly.

Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgments by specially appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

The system encourages countries to settle their differences through consultation. Failing that, they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of the ruling by a panel of experts and the chance to appeal the ruling on legal grounds.

Confidence in the system is bourne out by the number of cases brought to the WTO, around 300 cases in eight years compared to the 300 disputes dealt with during the entire life of GATT (1947-94).

(e) Policy Review:

The Trade Policy Review Mechanism's purpose is to improve transparency, to create a greater understanding of the policies that countries are adopting and to assess their impact. Many members also see the reviews as constructive feedback on their policies.

All WTO members must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO Secretariat.

D. SEZ,FDI

SEZ

The Special Economic Zone (SEZ) policy in India first came into inception on April 1, 2000. The prime objective was to enhance foreign investment and provide an internationally competitive and hassle free environment for exports. The idea was to promote exports from the country and realising the need that level playing field must be made available to the domestic enterprises and manufacturers to be competitive globally.
A legislation has been passed permitting SEZs to offer tax breaks to foreign investors. Over half a decade has passed since its inception, but the SEZ Bill has certain drawbacks due to the omission of key provisions that would have relaxed rigid labour rules. This has lessened India's chance of emulating the success of the Chinese SEZ model, through foreign direct investment (FDI) in export-oriented manufacturing.
The policy relating to SEZs, so far contained in the foreign trade policy, was originally implemented through piecemeal and ad hoc amendments to different laws, besides executive orders. In order to avoid these pitfalls and to give a long-term and stable policy framework with minimum regulation, the SEZ Act, '05, was enacted. The Act provides the umbrella legal framework, covering all important legal and regulatory aspects of SEZ development as well as for units operating in SEZs.
Since the rules will take care of many issues, the Special Economic Zone Act is likely to take some more time and the government is unlikely to notify them before September 1. The commerce and industry ministry is examining the domestic industry's comments on draft SEZ rules. A meeting of development commissioners of all SEZs will be convened soon to discuss the changes that need to be incorporated before they are notified to be placed before the parliament for final approval.
The objective of the SEZ Act was to create a hassle-free regime and the rules would be formulated keeping this in mind. The ministry is also holding talks with state governments as they have to play an important role in the development of SEZs.

What is a Special Economic Zone(SEZ)
Special Economic Zone (SEZ) is a specifically delineated duty-free enclave and shall be deemed to be foreign territory for the purposes of trade operations and duties and tariffs. In order words,

SEZ is a geographical region that has economic laws different from a country's typical economic laws. Usually the goal is to increase foreign investments. SEZs have been established in several countries, including China, India, Jordan, Poland, Kazakhstan, Philippines and Russia. North Korea has also attempted this to a degree.

Where are SEZs located in India

At present there are eight functional SEZs located at Santa Cruz (Maharashtra), Cochin (Kerala), Kandla and Surat (Gujarat), Chennai (Tamil Nadu), Visakhapatnam (Andhra Pradesh), Falta (West Bengal) and Noida (Uttar Pradesh) in India. Further an SEZ in Indore (Madhya Pradesh) is now ready for operation.

In addition 18 approvals have been given for setting up of SEZs at Positra (Gujarat), Navi Mumbai and Kopata (Maharashtra), Nanguneri (Tamil Nadu), Kulpi and Salt Lake (West Bengal), Paradeep and Gopalpur (Orissa), Bhadohi, Kanpur, Moradabad and Greater Noida (UP), Vishakhapatnam and Kakinada (Andhra Pradesh), Vallarpadam/Puthuvypeen (Kerala), Hassan (Karnataka), Jaipur and Jodhpur (Rajasthan) on the basis of proposals received from the state governments.

Who can set up SEZs? Can foreign companies set up SEZs

Any private/public/joint sector or state government or its agencies can set up an SEZ.

Yes, a foreign agency can set up SEZs in India.

Role of state governments in establishing SEZs

State governments will have a very important role to play in the establishment of SEZs. Representative of the state government, who is a member of the inter-ministerial committee on private SEZ, is consulted while considering the proposal. Before recommending any proposals to the ministry of commerce and industry (department of commerce), the states must satisfy themselves that they are in a position to supply basic inputs like water, electricity, etc.

SEZ's controlled by the government

In all SEZs the statutory functions are controlled by the government. Government also controls the operation and maintenance function in the seven central government controlled SEZs. The rest of the operations and maintenance are privatised.

Are SEZs exempt from labour laws

Normal labour laws are applicable to SEZs, which are enforced by the respective state governments. The state governments have been requested to simplify the procedures/returns and for introduction of a single window clearance mechanism by delegating appropriate powers to development commissioners of SEZs.

FDI

A **foreign direct investment (FDI)** is a controlling ownership in a business enterprise in one country by an entity based in another country.

Foreign direct investment is distinguished from portfolio foreign investment, a passive investment in the securities of another country such as public stocks and bonds, by the element of "control".

The origin of the investment does not impact the definition as an FDI: the investment may be made either "inorganically" by buying a company in the target country or "organically" by expanding operations of an existing business in that country.

Types

1. **Horizontal FDI** arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI.
2. **Platform FDI** Foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.
3. **Vertical FDI** takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country.

Methods

The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods:

- by incorporating a wholly owned subsidiary or company anywhere
- by acquiring shares in an associated enterprise
- through a merger or an acquisition of an unrelated enterprise
- participating in an equity joint venture with another investor or enterprise[l]

Forms of FDI incentives

Foreign direct investment incentives may take the following forms:

- low corporate tax and individual income tax rates
- tax holidays
- other types of tax concessions
- preferential tariffs
- special economic zones
- EPZ – Export Processing Zones
- Bonded warehouses
- Maquiladoras
- investment financial subsidie
- free land or land subsidies
- relocation & expatriation
- infrastructure subsidies

- R&D support
- derogation from regulations (usually for very large projects)

Governmental Investment Promotion Agencies (IPAs) use various marketing strategies inspired by the private sector to try and attract inward FDI, including Diaspora marketing.

- by excluding the internal investment to get a profited downstream.

Importance and barriers to FDI

The rapid growth of world population since 1950 has occurred mostly in developing countries. This growth has been matched by more rapid increases in gross domestic product, and thus income per capita has increased in most countries around the world since 1950.

An increase in FDI may be associated with improved economic growth due to the influx of capital and increased tax revenues for the host country. Host countries often try to channel FDI investment into new infrastructure and other projects to boost development. Greater competition from new companies can lead to productivity gains and greater efficiency in the host country and it has been suggested that the application of a foreign entity's policies to a domestic subsidiary may improve corporate governance standards. Furthermore, foreign investment can result in the transfer of soft skills through training and job creation, the availability of more advanced technology for the domestic market and access to research and development resources. The local population may benefit from the employment opportunities created by new businesses. In many instances, the investing company is simply transferring its older production capacity and machines, which might still be appealing to the host country because of technological lags or under-development, in order to avoid competition against its own products by the host country/company.

Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Manmohan Singh. As Singh subsequently became the prime minister, this has been one of his top political problems, even in the current times. India disallowed overseas corporate bodies (OCB) to invest in India. India imposes cap on equity holding by foreign investors in various sectors, current FDI in aviation and insurance sectors is limited to a maximum of 49%

Starting from a baseline of less than $1 billion in 1990, a 2012 UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010–2012. As per the data, the sectors that attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, US and UK were among the leading sources of FDI. Based on UNCTAD data FDI flows were $10.4 billion, a drop of 43% from the first half of the last year

Nine from 10 largest foreign companies investing in India(from April 2000- January 2011) are based in Mauritius . List of the ten largest foreign companies investing in India(from April 2000- January 2011) are as follows --

1. TMI Mauritius Ltd. ->Rs 7294 crore/$1600 million
2. Cairn UK Holding -> Rs6663 crores/$1492 million
3. Oracle Global (Mauritius) Ltd. -> Rs 4805 crore/$1083 million
4. Mauritius Debt Management Ltd.-> Rs 3800 crore/$956 million
5. Vodafone Mauritius Ltd. – Rs 3268 crore/$801 million
6. Etisalat Mauritius Ltd. – Rs 3228 crore
7. CMP Asia Ltd. – Rs 2638.25 crore/$653.74 million
8. Oracle Global Mauritius Ltd. – Rs 2578.88 crore / $563.94 million
9. Merrill Lynch(Mauritius) Ltd. – Rs 2230.02 crore / $483.55 million
10. Name of the company not given (but the Indian company which got the FDI is Dhabol Power company Ltd.)

In 2015 India emerged as top FDI destination surpassing China and the US. In first half of the 2015 India attracted FDI of $ 31 billion compared to $ 28 billion and $ 27 billion of China and the US respectively.

Reference:

1. *www.amosweb.com/cgi-bin/awb_nav.pl?s...*
2. *www.tutor2u.net/economics/.../a2-macro-macroeconomic-policy*
3. *www.economic.gov.za/about-us/programmes/...*
4. *quizlet.com/.../macroeconomics-principles-and-policy-chapter-5*
5. *wikipedia.org/wiki/Stock_and_flow*
6. *hspm.sph.sc.edu/courses/Econ/.../Stocksandflows/Stocksandflows.html*
7. *www.systemdynamics.org/DL-IntroSysDyn/stock.htm*
8. *www.business-prototyping.com/step-by.../stock-and-flow-diagrams*
9. *www.bis.org/speeches/sp121109a.html*
10. *www.wikipedia.org/wiki/Gross_national_product*
11. *www.diffen.com/difference/GDP_vs_GNP*
12. *www.investopedia.com/terms/g/gdp.asp*
13. *www.wikipedia.org/wiki/Circular_flow_of_income*
14. *www.investopedia.com/terms/circular-flow-of-income*
15. *www.tutor2u.net/blog/index.../study-note-the-circular-flow-of-income*
16. *https://en.wikipedia.org/wiki/Aggregate_demand*
17. *www.tutorsonnet.com › Economics › Macro Economics*
18. *www.investopedia.com/terms/a/aggregatedemand.asp*
19. *www.colorado.edu/economics/courses/econ2020/.../section7-main.html*
20. *books.google.co.in/books?isbn=8187140488*
21. *www.jstor.org/stable/40724193*