ULTIMATE CA

CA Foundation - New Syllabus
Super Chart Book by MVSIR
(Covers all chapters)

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Business Economics - Paper 4

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Chapter 1

Nature & Scope of Business Economics

(Weightage: 5 Marks)

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Two fundamental facts of Economics
- Unlimited Wants
- Resources are relatively scarce resources (Problem of Scarcity) and have alternative uses

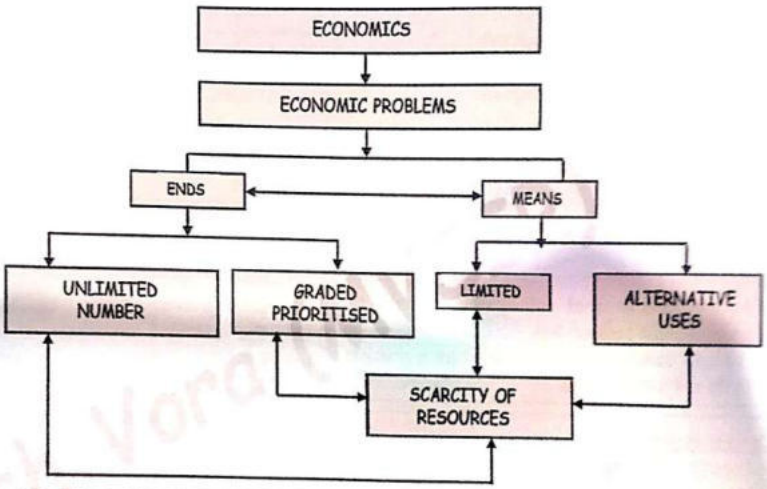
We cannot have everything we want with resources we have, we are forever forced to make choices.

Therefore, we choose to satisfy only some of our wants leaving many other wants unsatisfied.

Problem of scarcity is faced by EVERYONE in this world

Thus Economics is "कहानी घर घर की"

'Economics' is derived from Greek word 'Oikonomia'. Its meaning is 'household management'.



Economists	Various Definitions of Economics
Adam Smith	Wealth Definition Limitation : neglect of immaterial services
J B Say	Economics is a "Science which deals with wealth"
Alfred Marshall	Welfare Definition
Lionel Robbins or Robinson	Scarcity Definition Economics is neutral between ends.
Paul A. Samuelson	Growth Definition

Economics is the study of the processes by which relatively scarce resources are allocated to satisfy competing unlimited wants of human beings in a society.
Economics concerns itself with
i. the crucial concern of how a nation allocates its scarce productive resources to various uses;
ii. it also deals with the processes by which the productive capacity of these resources is increased and
iii. with the factors which, in the past, have led to sharp fluctuations in the rate of utilisation of these resources.

Till 19th century, Economics was known as 'Political Economy'
Father of Economics - Adam Smith. He wrote a book 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776)

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❑ The study of economics helps us in-
- Developing an analytical approach
- Choosing the best course of action from among the different alternative courses

❑ However, it is necessary to remember that-
- most economic problems are of complex nature and
- are affected by several forces

❑ The study of Economics-
- cannot ensure that all problems will be appropriately tackled, but,
- it would enable a student to examine a problem in its right perspective

Decision making refers to process of
- selecting an appropriate alternative that will provide the
- most efficient means of attaining a desired end,
- from two or more alternative courses of action.

Business Economics may be defined as the use of economic analysis to make business decisions involving the best use of an organization's scarce resources.

Joel Dean defined "Business Economics" as use of economic analysis in formulation of business policies.

Business Economics is aka. Applied Economics or Managerial Economics

Micro Economics	Macro Economics
Study of behaviour of individuals or group of units rather than all the units combined It examines how individual units make decisions as to how to efficiently allocate their scarce resources	Study of economy as a whole. It analyzes the overall economic environment. Aka - Aggregate Economics
Few areas under Micro- Economics are: (i) Product pricing; (ii) Consumer behaviour; (iii) Factor pricing; (iv) The economic conditions of section of people; (v) Behaviour of firms; and (vi) Location of industry.	Few areas under Macro- Economics are: (i) National Income and National Output; (ii) General price level and interest rates; (iii) Balance of trade and balance of payments; (iv) External value of currency; (v) The overall level of savings and investment; and (vi) The level of employment and rate of economic growth.

NOTES

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Nature of Business Economics

1) **Business Economics is a Science**
Economics is a branch of social science of how people in a society focused on production, distribution & consumption of goods/services.

2) **Based largely on Micro Economics**

3) **Incorporates elements of Macro Analysis**

4) **Business Economics is an art**

5) **Use of Theory of Markets and Private Enterprises**

6) **Pragmatic in Approach**
Micro-Economics → abstract & purely theoretical (due to unrealistic assumptions)
Business Economics → pragmatic (tackles practical problems)

7) **Interdisciplinary in nature**
Incorporates tools from other disciplines (subjects)

8) **Normative in Nature**
- Positive Economics - Descriptive, "What is" current situation, analyses cause & effect relationship between variables in objective & scientific manner
- Normative Economics - Prescriptive, "What should be" done for welfare, involves value judgements

Scope of Business Economics

Operational / Internal Issues (solved using Micro-Economics)	Environmental / External Factors (solved using Macro-Economics)
Those issues that arise within organisation and are within control of management.	These are not within control of management; thus organization should fine-tune its policies to minimise their adverse effects
i. Demand Analysis and Forecasting Demand analysis pertains to behaviour of consumers in market. ii. Production and Cost Analysis Production theory explains relationship between inputs & output. Cost analysis explains behaviour of costs when variables- output, time period and size of plant change iii. Inventory Management iv. Market Structure and Pricing Policies v. Resource Allocation vi. Theory of Capital and Investment Decisions vii. Profit Analysis viii. Risk and Uncertainty Analysis	Major macro-economic factors- ❑ Stage of business cycle ❑ Trends in - national income, employment, prices, saving & investment. ❑ Government's economic policies like industrial policy, competition policy, and fiscal policy, foreign trade policy etc ❑ Working of central banks & financial sector ❑ Socio-economic organisations like trade unions, producer and consumer unions and cooperatives. ❑ Social and political environment.

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ECONOMICS CHAPTER 1 - NATURE & SCOPE OF BUSINESS ECONOMICS

Basis of Difference	Economics	Business Economics
Meaning	Framing of economic principles to solve economic problems	Application of economic principles to solve business problems.
Character	Micro & Macro economic	Micro economic
Main Task	Fulfilment of needs of individuals & also entities.	Proper decision making in a particular business entity
Nature	Positive as well as normative	Normative
Scope	Wider Scope	Narrow scope
Branches	It has business economics as its applied branch.	It is an applied branch of economics
Concerned with	All theories relating to production, distribution & consumption	Only profit theory ignoring other theories
Analysis Invovled	Analysis of macro level issues like growth, inflation & emp.	Analysis of micro level issues like demand, supply & profit
Concentration	only on economic aspects	Both economic as well as non-economic aspects of any business problem
Validity of Assumptions	Based on certain assumptions	Some assumptions become invalid when applied.

ECONOMICS CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

Every economic system has to deal with central problem of scarcity of resources relative to the wants for them. This is generally called 'the central economic problem'.

1) **What to produce?** → What & how much to produce
2) **How to produce?** → Capital or Labour Intensive
3) **For whom to produce?** → How G/S distributed
4) **What provisions are to be made for economic growth?**

3 Types of Economies-

1) Capitalist - All resources are owned and controlled by private individuals for profit
2) Socialist - Material resources are owned by **State** (aka Govt. or Central Planning Authority)
3) Mixed - It depends on both markets and governments for allocation of resources

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Capitalism

Aka free market economy or laissez-faire economy or market economy

All means of production are owned and controlled by private individuals for profit. In short, private property is the mainstay of capitalism and profit motive is its driving force.

Eg- USA, UK, Hong Kong etc.

Characteristics

- Profit motive is driving force.
- Right to private property
- Freedom of enterprise & economic choice (consumer sovereignty)
- Absence of Government Interference
- Competition (Efficiency increases, optimum allocation, cost minimized; but wastage of resources due to advertisement)

Merits

- Consumers benefitted - many good quality goods at low prices
- Self-regulating and resources allocated automatically by price mechanism
- Functions in a democratic framework
- Encourages enterprise and risk taking

Demerits

- Vast economic inequality and social injustice, splits society into 'haves' and 'have-nots'
- Exploitation of labour & consumers
- Resource misallocation - production of more luxury goods
- Conspicuous & unethical consumption - environmental degradation.

How do capitalist economies solve central problems?

1) What to produce?
decided by consumers who show preferences by spending on goods which they want

2) How to produce?
If labour is relatively cheap than capital, then use labour-intensive method & vice versa

3) For whom to produce?
Higher the income, higher buying capacity and higher demand for goods. Goods produced for people having buying capacity

4) Provision (Saving & Invt)
Interest Rate on saving high- more saving
More profit expectation- more investment

Notes

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ECONOMICS CHAPTER 1 - UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

Socialism

- Aka **Command Economy** or **Controlled Economy** or **Centrally Planned Economy**
- Concept given by **Karl Marx** and **Frederic Engels** in 'The Communist Manifesto' (1848)
- Production by Govt. is aimed at **maximizing welfare** of public

Characteristics
- Collective Ownership
- Economic planning
- Absence of Consumer Choice
- Relatively Equal Income Distribution
- Minimum role of Price Mechanism or Market forces - Prices prevailing here are '**administered prices**' which are set by Govt.
- Absence of Competition

Merits
- Central planning of resources- Rapid development, better utilization, waste avoided
- Unemployment is minimised,
- Business fluctuations are eliminated
- Right to work and minimum standard of living
- **Labourers and consumers are protected from exploitation**
- Comprehensive social security

Demerits
- Bureaucracy & red tapism, inefficiency and delays, corruption, favouritism
- **Takes away the basic right- right to property**
- Does not provide necessary incentives to hard work
- Consumers have **no freedom of choice**
- **Extreme form of** socialism is not practicable (Socialist economy is a **myth**)

How do socialist economies solve central problems? - **Central Planning Authority**

Mixed Economy

- It **includes the best features of both capitalism & socialism**
- Private enterprise is allowed to do any type of economic activity However, the Govt. imposes measures to control and regulate private sector
- The Government itself runs important and selected industries and eliminate the free play of profit motive and self-interest.

In a mixed economy, there are three sectors of industries:
1) Private sector
2) Public sector
3) Combined sector

Merits
- Economic freedom & existence of private property which **ensure incentive to work and capital formation.**
- Price mechanism and competition → leads to **efficient decisions**
- Consumers benefitted → **consumers' sovereignty** & **freedom of choice**
- **Incentives** for **innovation & technological progress.**
- **Encourages enterprise and risk taking.**
- Advantages of **economic planning & rapid economic development**
- **Greater economic and social equality** and freedom from exploitation
- **Disadv. of competition averted** through government's **legislations**

Demerits
- **Excessive controls by state** → reduced incentives & constrained growth
- Poor implementation of planning
- Higher rates of **taxation**
- Undue delays, Lack of efficiency, Corruption, Wastage of resources
- **Poor performance** of the public sector

How do mixed economies solve central problems?
It uses a **mix of both price mechanism and central planning**

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Business Economics - Paper 4

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Chapter 2

Theory of Demand & Supply

(Weightage: 10 Marks)

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'Demand' refers to quantity of a good or service that buyers are willing and able to purchase at various prices during a given period of time.

In Economics, demand is not the same thing as desire to purchase.

The effective demand for a thing depends on
i. desire
ii. means to purchase and
iii. willingness to use those means for that purchase.

Two things about quantity demanded.
1) Quantity demanded is always expressed at a given price. At different prices different quantities are demanded.
2) Quantity demanded is a flow concept. We are not concerned with single isolated purchase, but with a continuous flow of purchases and we must therefore express demand as 'so much per period of time'.

Determinants of Demand

Factors which influence the demand for a commodity are determinants of demand

1) **Price of the good**
Ceterus paribus, price increases → demand decreases & vice versa

2) **Price of related goods**
- **Complementary goods** (goods used together) → Eg Car & Petrol → Price of Petrol increases, demand of car decreases [inverse relation]
- **Substitute/Supplementary/Competing goods** (goods which satisfy same want) → Eg Tea & Coffee → Price of tea increases, demand of coffee increases [direct relation]

3) **Disposable Income of Consumers**
Generally, higher the income → higher the demand, however sometimes it depends on nature of goods.

4) **Taste & Preferences**
Modern or more fashionable goods have higher demand. However preferences may get affected by 4 types of effects. (Refer next page)

5) **Consumers' Expectations**
If consumer expects → Increase in future price OR Increase in future income OR Shortage of good in future→ Current Dem. increases & vice versa

6) **Other Factors**
(Refer next page)

Nature of Good	Meaning
Normal Goods Eg- Furniture, Automobile, Consumer Durables	Increase in income leads to higher demand.
Essential Consumer Goods Eg- Food Grain, Cooking Oil, Fuel	Satisfies basic needs of consumers. Increase in income leads to higher demand, but this increase will be less than proportionate to the increase in income.
Durable Goods Eg- TV, Car, House	As people become richer, there is a relative decline in importance of non-durable goods & rise in importance of durable goods.
Inferior Goods Eg- Cheap substitutes, Local goods	Demand rises only up to a certain level of income & decreases with an increase in income beyond this level. A same good may be normal for one condition & inferior in another.
Luxury / Prestige Goods Eg- Sports Car etc	Demand rises beyond a certain level of consumers' income and keep rising as income increases.

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4 Types of "Effects" which influences consumers' Tastes and preferences of consumers	
Demonstration Effect (Dekha-Dekhi)	➢ Given by James Duesenberry, ➢ Desire of people to emulate (imitate) the consumption behaviour of others. ➢ People buy or have things because they see that other people are able to have them.
Bandwagon Effect (Bhed-Chaal)	➢ It refers to extent to which the demand for a commodity is increased due to the fact that others are also consuming the same commodity. (Herd Mentality) ➢ Purchase commodity in order to be fashionable or stylish or to conform to the people they wish to be associated with.
Snob Effect (function of consumption of others)	➢ By 'snob effect' we refer to the extent to which the demand for a consumers' good is decreased owing to the fact that others are also consuming the same commodity. ➢ Desire of people to be exclusive; to be different; to dissociate themselves from the "common herd."
Veblen Effect (function of price)	➢ Given by Thorstein Veblen. ➢ Highly priced goods are consumed by status seeking rich people to satisfy their need for conspicuous consumption. ➢ People buy these goods to show that they have style, class, money, and good taste.

6) Other Factors (Determinants of Demand)	
a) Size of population	Larger the size of population, higher the demand of goods
b) Age Distribution of population	More old people, then demand for spectacles, sticks, etc. will be high. If more of children, demand for toys, toffees, etc. will be more. If there is migration from rural areas to urban areas, there decrease in demand in rural areas.
c) The level of National Income & its Distribution	Higher the national income, higher the demand Rich people has lower propensity to consume (PTC) and poor have higher PTC. Uneven Distribution, then PTC less, demand less Even Distribution, then PTC more, demand more
d) Consumer-credit facility and interest rates	Low interest rate, high demand More credit available, then high demand
e) Government policies and regulations	Tax increase, demand decrease Subsidy increase, demand increase Ban or restriction increase, demand decrease

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Demonstration or Bandwagon Effect	Snob Effect
It is a psychological effect in which people do the same what others are doing. They do not have their own belief and thinking.	It is understood as the desire to possess a unique commodity having a prestige value. It is quite opposite to the bandwagon or demonstration effect.
It leads to increase in demand of a particular commodity.	It leads to decrease in demand of a particular commodity.
Example: When some people start investing money in share market then many people start following the same without considering its advantages and disadvantages	**Example:** If Miss. X and Miss. Y are rich rivals of each other and if in any party Miss. X wears an expensive dress and on seeing it Miss. Y who also having the same dress decided to reject the use of the same dress further. Rather Miss. Y will try to use even more expensive one.

Law of Demand

As per **Alfred Marshall**, Law of demand states- ceterus paribus (other things being equal), if price of commodity falls, quantity demanded will rise and vice versa

The **quantity demanded** is amount of a good or service that consumers are willing to buy at a given price, holding other factors constant. The quantity demanded can exceed quantity actually sold.

Demand Schedule

A **demand schedule** is a table showing quantities of a good that buyers would demand at different prices, per unit of time, with all other variables held constant. Demand schedule obeys law of demand.

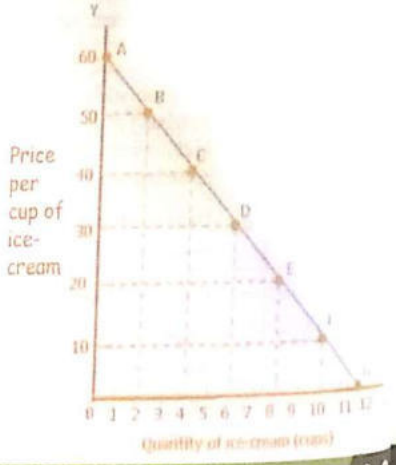
	Price per cup of ice-cream (in Rs)	Qty ice-cream demanded per week (in cups)
A	60	0
B	50	2
C	40	4
D	30	6
E	20	8
F	10	10
G	0	12

Demand Curve

A **demand curve** is a graphical presentation of the demand schedule. It is obtained by plotting Price on Y-axis & Quantity Demanded on X-axis.

Slope of demand curve is → $-\Delta P/\Delta Q$
Negative sign in slope → consistent with law of demand.

Demand curve can be linear (straight line) or curvilinear (slope may vary along curve).



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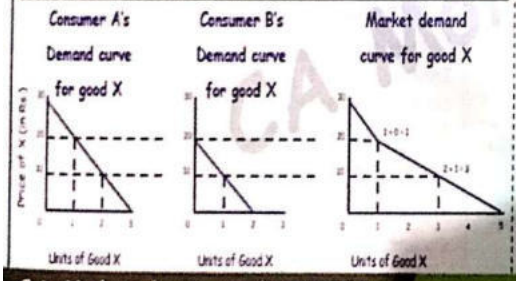
Market Demand Schedule

Market demand is total quantity that all buyers of a commodity are willing to buy per unit of time at a given price, other things remaining constant.

Price of Good X (in Rs)	Qty Demanded (in units)		Total Market Demand
	Consumer A	Consumer B	
0	3	2	5
10	2	1	3
20	1	0	1
30	0	0	0

Market Demand Schedule

The market demand curve is obtained by horizontal (lateral) summation of all individual demand curves. If we plot the market demand schedule on a graph, we get the market demand curve.



Demand Function

Demand function states relationship between
- demand for a product (dependent variable) and
- its determinants (independent or explanatory variables).

A demand function may be expressed as follows:
$D_x = f$ (Price of Good X, Income, Price of Related Goods)

Demand Equation

The straight-line demand curve where we hold everything else constant other than price, can be described by a linear demand function.

$$Q = a - bP$$

Where 'a' is the vertical intercept and 'b' is the slope.

Rationale of the law of demand

The reason why price & demand are inversely related and why demand curve slopes downward.

1) Utility maximising behaviour of Consumers
According to Marshall, consumer has diminishing utility for each additional unit of a commodity and thus, he will be willing to pay only less for each additional unit.

2) Arrival of new consumers
When price falls, some consumers who could not afford to buy earlier may now be able to buy it.

3) Different Uses
Goods having multiple uses→ Price decrease → used for varied purposes & demand increase. Eg- Milk, Electricity etc.

4) Price effect
The total fall in quantity demanded due to an increase in price is termed as Price effect.

The price effect is sum of its two components namely: (as explained by Hicks & Allen)
i) substitution effect
ii) income effect.

i) Substitution effect:
When the price of a commodity falls, it becomes relatively cheaper than other commodities, & it induces consumers to increase demand of commodity whose price has fallen.

When price falls, substitution effect is always positive; i.e it will always cause more to be demanded.

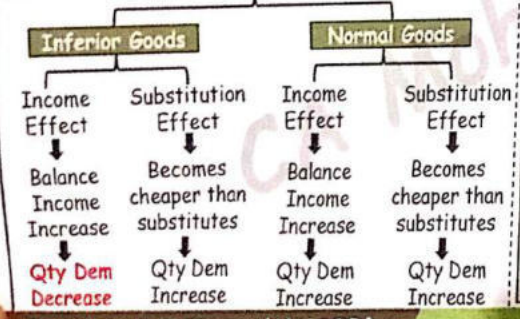
The substitution effect will be stronger when:
(a) the goods are closer substitutes
(b) there is lower cost of switching to the substitute good
(c) there is lower inconvenience while switching to the substitute good

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ii) Income effect

- Increase in demand on account of an increase in real income is known as income effect.
- When price falls, consumer can
  - buy same quantity with lesser money or
  - he can buy more of same commodity with same amount.
- In case of inferior goods,
  - income effect works in opposite direction to substitution effect.
  - expansion in demand due to a price fall will take place only if SE > IE.
  - Here, violation of law of demand takes place when Negative IE > SE

When price falls



Exceptions to the law of demand

1) Conspicuous goods

- Aka. Prestige goods, Snob goods, Veblen goods.
- Some consumers measure utility of a commodity by its price i.e., if commodity is expensive they think that it has got more utility. Thus, they buy less of this commodity at low price & more of it at high price. Eg- Diamonds
- Found out by Veblen in his doctrine of "Conspicuous Consumption" → this effect is called Veblen effect or prestige goods effect.

2) Giffen Goods

- Sir Robert Giffen - found that as price of bread increased, the British workers purchased more bread.
- Generally those goods which are
  - inferior,
  - with no close substitutes easily available and
  - which occupy a substantial place in consumer's budget

  are called 'Giffen goods'.
- Giifen goods exhibit
  - Direct price-demand relationship (upward sloping demand curve)
  - Indirect income-demand relationship (downward sloping engel curve)
- All Giffen Goods are inferior Goods, but all inferior goods are not Giffen Goods

3) Conspicuous necessities

- Demand for certain goods is affected by demonstration effect of consumption pattern of their social group. These goods, due to constant usage, become necessities of life
- For example, despite increase in prices of TV, refrigerators, etc., their demand does not fall.

4) Future expectations about prices

- When prices are rising, households expecting that prices in future will be still higher, tend to buy larger quantities currently & vice versa.

5) Irrational Consumer

- A person may demand larger quantity even at a higher price because he may be ignorant of ruling price
- Irrational people make impulsive purchases without any rational calculations about price and usefulness.

6) Demand for necessaries

Irrespective of price changes, people have to consume minimum quantities of necessities. Eg- Food, power, water, gas etc.

7) Speculative goods

In stock market, more is demanded when prices are rising and less will be demanded when prices decline.

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ECONOMICS CHAPTER 2 - THEORY OF DEMAND & SUPPLY | UNIT 1 - THEORY OF DEMAND

Demand

Demand refers to entire relationship between price & quantity demanded.

It is represented by entire demand schedule & demand curve.

"Changes in Demand" occur due to changes in factors other than price of the good.

Favourable change in any factor other than price	Unfavourable change in any factor other than price
Increase in Demand → Rightward shift in demand curve	Decrease in Demand → Leftward shift in demand curve
Eg- Increase in Income (normal goods) Increase in price of substitutes etc.	Eg- Decrease in Income (normal goods) Increase in price of complements etc.

Quantity Demanded

Quantity demanded is the quantity which is demanded at a specific price.

represented by a point on demand curve.

"Changes in Quantity Demanded" occur due to changes in price of goods concerned.

Increase in price of goods concerned	Decrease in price of goods concerned
Contraction of Demand → Upward movement along the same demand curve	Expansion or Extension of Demand→ Downward movement along the same demand curve

- When demand increases due to factors other than price, firms can sell more at the existing prices resulting in increased revenue.
- Objective of advertisement by any firm is to shift demand curve to right and to reduce elasticity of demand.
- However, firms have to incur expenditure on advertisement and sales promotion devices.

Elasticity of Demand

Elasticity of demand → Responsiveness of quantity demanded to a change in one of determinants of demand

I) Price Elasticity of Demand (Ep)

Responsiveness of quantity demanded to a change in price of the good.

Methods of Calculating Price Elasticity of Demand

Percentage Method

$$\frac{\%\,\Delta Qd}{\%\,\Delta P}$$

OR

$$\frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

OR

$$\frac{1}{\text{Slope}} \times \frac{P}{Q}$$

Point Method

- **Using Derivative**

$$\frac{-dQ}{dP} \times \frac{P}{Q}$$

- **Geometric Method**

$$\frac{\text{Lower Segment}}{\text{Upper Segment}}$$

Arc Method

$$\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}$$

$$\frac{Q2 - Q1}{Q2 + Q1} \times \frac{P2 + P1}{P2 - P1}$$

Total Outlay Method

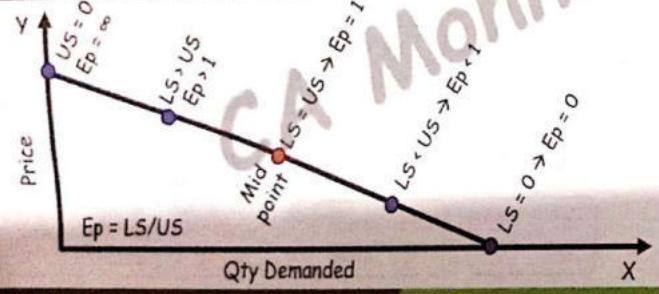
Change in Price	Demand		
	Unitary Elastic	Elastic	Inelastic
Price Increase	TR remains same	TR Decreases	TR Increases
Price Decrease	TR remains same	TR Increases	TR Decreases

Using Total Outlay method we can only say whether the demand for a good is elastic or inelastic we cannot find out the exact coefficient of price elasticity

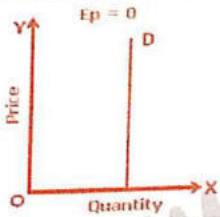
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Additional Notes - Price Elasticity of Demand

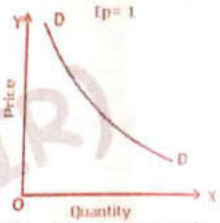
- Change in Quantity = ΔQ = New Q - Old Q
- Percentage change in Qty = %ΔQ = [(New Q - Old Q) / Old Q] x 100
- Change in Price = ΔP = New P - Old P
- Percentage change in Price = %ΔP = [(New P - Old P) / Old P] x 100
- When no method is specified in question → use percentage method.
- When price change is infinitesimal small, then use point method
  - ❑ When data of Qty Demanded is given as an equation → use point (derivative) method
  - ❑ When questions mentions "demand curve is meeting the two axis" → use point (graphical) method
- When price elasticity is to be calculated between two points → use arc method.
- When question mentions about changes in price and changes in total expenditure/revenue → use total outlay method.



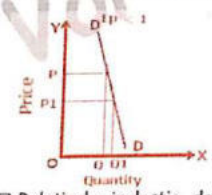
Value of price elasticity of demand varies from minus infinity to approach zero, however while interpreting its value we ignore -ve sign (to draw conclusions)



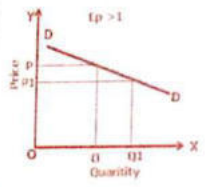
- ❑ Perfectly inelastic demand (Ep = 0)
- ❑ Vertical Demand Curve
- ❑ Parallel to Y-axis or Price axis
- ❑ When price changes → %ΔQ = 0



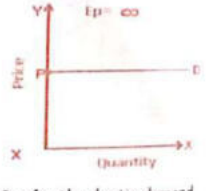
- ❑ Unitary Elastic demand (Ep = 1)
- ❑ Demand Curve→ Rectangular Hyperbola
- ❑ %ΔQ = %ΔP



- ❑ Relatively inelastic demand (Ep < 1)
- ❑ Steeper Demand Curve
- ❑ %ΔQ < %ΔP
- ❑ When price falls →buyers are unwilling to significantly contract demand.
- ❑ Qty dem. here is relatively insensitive to price changes.



- ❑ Relatively elastic demand (Ep > 1)
- ❑ Flatter Demand Curve
- ❑ %ΔQ > %ΔP
- ❑ Qty dem. is relatively sensitive to price changes



- ❑ Perfectly elastic demand
- ❑ Ep = ∞ (Infinite)
- ❑ Horizontal Demand Curve
- ❑ Parallel to X-axis or qty axis
- ❑ Small price reduction raises demand from 0 to ∞
- ❑ Small price increase, Qd = 0
- ❑ Found in Perfectly competition market

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Additional Notes - Total Outlay Method

Generally when price increases, there are two effects which act in opposite directions on revenue.

Price effect: After a price increase, each unit sold sells at a higher price, which leads to more revenue.

Quantity effect: After a price increase, fewer units are sold, which leads to lower revenue.

What will be the net effect on total revenue?

When price increase, & demand is	PE vs QE		Net effect on TR
Inelastic Demand (Ep < 1)	QE < PE	Decr in TR < Incr in TR	TR will increase
Elastic Demand (Ep > 1)	QE > PE	Decr in TR > Incr in TR	TR will decrease
Unit Elastic Demand (Ep = 1)	QE = PE	Decr in TR = Incr in TR	TR will remain same

II) Advertisement Elasticity of Demand (Ea) → Value always positive

Percentage Method (Ea)

$$\frac{\%\Delta \text{ Qty Dem.}}{\%\Delta \text{ Advt Exp}} \text{ OR } \frac{\Delta Q}{\Delta A} \times \frac{A}{Q}$$

Arc Method (Ea)

$$\left[\frac{Q2 - Q1}{Q2 + Q1} \times \frac{P2 + P1}{P2 - P1}\right]$$

Determinants of Price Elasticity of Demand

1	Availability of Substitutes	➢ Goods having substitutes → Elastic Demand ➢ No substitutes → Inelastic Demand ➢ Goods as a group (generic) → Inelastic Demand (eg- petrol) ➢ If we consider brands → Elastic Demand (eg- IOCL Petrol, Reliance Petrol etc)
2	Position of a commodity in a consumer's budget	➢ Greater the proportion of income spent on a commodity → greater elasticity of demand & vice-versa. ➢ Salt, matches, buttons → inelastic dem ➢ Rental apartments, clothing → elastic dem
3	Nature of the need that a commodity satisfies	➢ Luxury goods (possible to postpone consumption) → elastic demand ➢ Necessities (cannot be postponed) → inelastic dem.
4	No. of uses of which a commodity	➢ More the possible uses of a commodity, the greater its elasticity of demand
5	Time period	➢ Long time period to adjust to price change → elastic ➢ Short time period → inelastic demand
6	Consumer habits	Consumer is habitual of a good → inelastic demand
7	Tied demand	Tied demand → inelastic (Eg pen & refill)
8	Price Range	➢ Very high price or very low-price range → inelastic ➢ Middle range → elastic demand.
9	Minor complement items	Cheap & complementary items to be used with a costlier product → inelastic demand.

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III) Income Elasticity of Demand (Ey)

Responsiveness of quantity demanded to a change in income of the consumer

- Proportionate Method (Ey)
- Percentage Method (Ey)
- Arc Method (Ey)

Proportionate Method (Ey)

If after an increase in income, the proportion of income spent on a good	Type of Income Elasticity
Remains Same	Income Elasticity = 1
Increases	Income Elasticity > 1
Decreases	Income Elasticity < 1

Percentage Method (Ey)

$$Ey = \frac{\%\Delta \text{ Qty Demanded}}{\%\Delta \text{ Income}} \quad \text{OR} \quad Ey = \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$$

Value of Ey	Type of Good
Ey = 0	Demand is unresponsive to change in income. (No specific type of good)
Ey is Positive → Ey > 0	Normal Goods
0 < Ey < 1	Necessities
Ey > 1	Luxury goods
Ey is Negative → Ey < 0	Inferior goods

Arc Method (Ey)

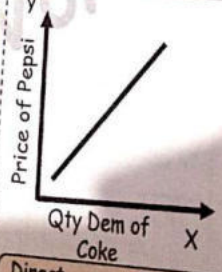
$$Ey = \left[\frac{Q2 - Q1}{Q2 + Q1} \times \frac{P2 + P1}{P2 - P1}\right] \quad \text{OR} \quad Ey = \left[\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}\right]$$

IV) Cross Elasticity of Demand (Ec)

Responsiveness of quantity demanded of Good X to a change in price of related good Y. Where Goods X & Y can be-

Substitute Goods

Two goods which satisfy the same want.
Eg- Pepsi & Coke

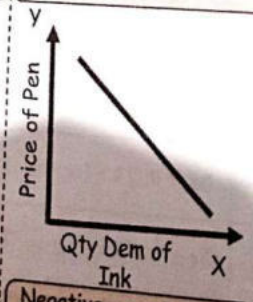


Direct or Positive relation between Price of Pepsi & Qd of Coke.

Upward sloping cross demand curve

Complementary Goods

Two goods which are to be consumed together.
Eg- Pen & Ink



Negative or Inverse relation between Price of Pen & Qd of Ink.

Downward sloping cross demand curve

Unrelated Goods

Two goods having no relation between them
Eg- Laptop & Burger

No relation between Price of Laptop & Qd of Burger.

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Cross Elasticity of Demand (Ec)

Percentage Method (Ec)

$$Ec = \frac{\%\Delta \text{ Qty Dem of X}}{\%\Delta \text{ Price of Y}} \quad OR \quad Ec = \frac{\Delta Qx}{\Delta Py} \times \frac{Py}{Qx}$$

Arc Method (Ec)

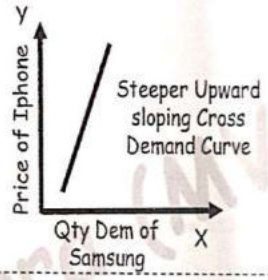
$$Ec = \left[\frac{Q2 - Q1}{Q2 + Q1} \times \frac{P2 + P1}{P2 - P1}\right] OR \left[\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}\right]$$

Value of Ec	Type of Good	
Ec = 0	Unrelated Goods	
Ec is Positive → Ec > 0	Ec is Positive & Low	Remote Substitutes
	Ec is Positive & High	Close Substitutes
	Ec is Positive & Infinite	Perfect Substitutes
Ec is Negative → Ec < 0	Ec is slightly below zero	Weak Complements
	Ec is Negative & High	Strong Complements
	Ec is Negative & Infinite	Perfect Complements

Remote Substitutes

2 Goods are substitutes but have less similarity. [Ec is +ve & low]

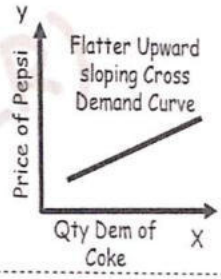
Eg- Iphone & Smansung Mobile



Close Substitutes

2 Goods are substitutes & are very similar. [Ec is +ve & high]

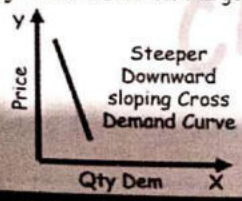
Eg- Pepsi & Coke etc.



Weak Complements

Ec is -ve & slightly below zero

Eg- iPhone & Local co. charger



Strong Complements

Ec is -ve & high

Eg- iPhone & Apple co. charger



NOTES

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Introduction

All desires, tastes and motives of human beings are called wants in Economics. Since resources are limited, we must choose between urgent wants and not so urgent wants.

Nature of Human Wants

- Unlimited → never completely satisfied.
- Differ in intensity→ Some are urgent ,others are less intensely felt
- Satiable (capable of being satisified)
- Competitive→ resources are scarce in relation to wants.
- Complementary→ Some wants satisfied only by using multiple goods together.
- A particular want may be satisfied in alternative ways
- Wants are subjective (vary person to person) and relative (vary with time & place)
- Some wants recur (non-durable goods) whereas others do not occur again and again (durable goods)
- Wants may become habits and customs
- Wants are affected by income, taste, fashion, advertisements and social norms and customs
- Wants arise from multiple causes such as physical and psychological instincts, social obligations and individual's economic and social status

Classification of Wants

Necessaries	Necessaries for life or existence	Necessary to meet minimum physiological needs → minimum amount of food, clothing & shelter.
	Necessaries for efficiency	Necessities required to maintain longevity, energy and efficiency of work. Eg- nourishing food, adequate clothing, clean water etc
	Conventional necessaries	Not necessaries in reality but arise either due to pressure of habit or due to compelling customs & conventions.
Comforts		While necessaries make life possible comforts make life comfortable and satisfying. Comforts are less urgent than necessaries. Eg- Tasty and wholesome food, good house, clothes that suit different occasions, audio-visual and labour saving equipments etc.
Luxuries		Wants which are superfluous and expensive. Not essential for living. Eg- expensive clothing, exclusive motor cars, classy furniture, goods used for vanity

What is Utility ?

- Concept of utility is used in neo classical Economics to explain operation of law of demand.
- Utility to "that property in any object, whereby it tends to produce benefit advantage, pleasure, good or happiness".
- Utility→ anticipated / expected satisfaction
- A commodity has utility for a consumer even when it is not consumed .
- It is a subjective entity and varies with person, time & place. It should be noted that utility is not the same thing as usefulness.
- From the economic standpoint, even harmful things like liquor, may be said to have utility because people want them. Concept of utility is ethically neutral.

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Utility

Utility hypothesis forms basis of theory of consumer behaviour

Cardinal Utility Approach	Ordinal Utility Approach
Cardinal Utility is the utility wherein the satisfaction derived by the consumers from the consumption of good or service can be measured numerically.	Ordinal Utility states that the satisfaction which a consumer derives cannot be measured numerically. Here utility measured in terms of ranking of preferences of a commodity when compared to each other
Marginal Utility Analysis propounded by Marshall	Indifference Curve Analysis propounded by Hicks and Allen

Marginal Utility Analysis

- Marginal utility theory, formulated by Alfred Marshall, seeks to explain how a consumer chooses to spend his income on different goods and services so as to maximize his utility.
- The law of diminishing marginal utility states that→ "The additional benefit which a person derives from a given increase in the stock of a thing diminishes with every increase in the stock that he already has."
- Since each want is satiable, as a consumer consumes more and more units of a good, the intensity of his want for the good goes on decreasing and a point is reached where the consumer no longer wants it.

Gulab Jamun	Marginal Utility (MU) (in Utils)	Total Utility (TU) (in Utils)
1st Piece	50	50
2nd Piece	40	90
3rd Piece	28	118
4th Piece	10	128
5th Piece	0	128
6th Piece	-5	123

Observations from above table

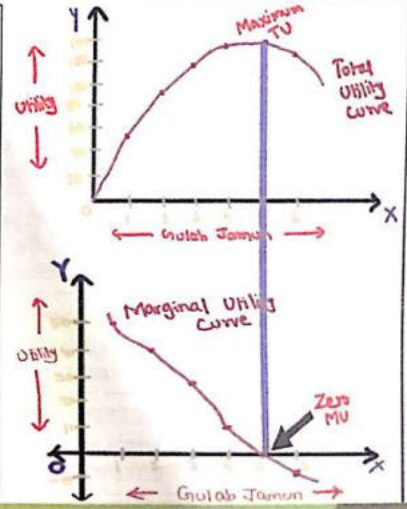
1) MU can be positive ,zero or negative.
2) MU diminishes throughout.
3) TU rises as long as MU is positive, but at a diminishing rate because MU is diminishing.
4) When MU = 0, TU is maximum. It is a satiation point or saturation point. Once this point is reached, consumer would refuse any extra unit even if it were free
5) When MU is negative, TU is diminishing.
6) MU = Slope of TU.

Total Utility (TU)

- TU is sum of marginal utilities derived from consumption of different units.
- $TU = MU_1 + MU_2 + \ldots + MU_n$

Marginal Utility (MU)

- MU is addition made to total utility by consumption of one additional (marginal) unit of a commodity.
- $MU_n = TU_n - TU_{n-1}$



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Assumptions of Marginal Utility Analysis

Rationality	Consumer is rational & attempts to attain maximum satisfaction from his limited money income.
Cardinal Measurability of Utility	Utility is a cardinal concept→ measurable & quantifiable→ in utils. Compare different commodities & express which commodity gives him greater utility & by how much
Money is the measuring rod of utility	The amount of money which a person is prepared to pay for a unit of a good is a measure of utility which he derives.
Other factors 'constant'	Price of commodity, tastes & preferences, income, habits, etc are assumed constant.
Continuity in consumption	No time gap or interval between consumption of different units.
Homogenous Units	All units consumed should be identical in nature. If successive units show variation or are of superior quality, diminishing utility may not occur.
Standard Units	Eg- spoonfuls of juice are too small units & in such cases we could consider the normal units as a glass of juice. Also, the commodity should be divisible in nature.
Constancy of the Marginal Utility of Money	If MU of money changes as income changes, the measuring-rod of utility becomes unstable & thus would be inappropriate for measurement.
The Hypothesis of Independent Utility	Total utility which a person gets from whole collection of goods is simply the sum total of separate utilities of the goods. The theory ignores complementarity between goods.

Assumptions of Marginal Utility Analysis

Unrealistic assumptions	Assumptions like cardinal measurability of utility, constancy of marginal utility of money, continuous consumption & consumer rationality are unrealistic.
Case of related goods	Utility is not independent. Shape of utility curve may be affected by presence or absence of substitutes or complements. Eg- Utility obtained from tea may be seriously affected if no sugar is available.
Law is not universal	Exceptions to this law- ➢ Prestigious goods → gold, cash, diamond etc ➢ Hobbies, rare collections etc ➢ People who seek greater knowledge and information will be more satisfied with every additional information secured by them. ➢ Creative art, painting, music, poetry etc ➢ Habit forming commodities → alcohol, cigarettes, & computer games etc. ➢ People with miserly behaviour → as accumulation of every additional unit of money → gives more satisfaction.

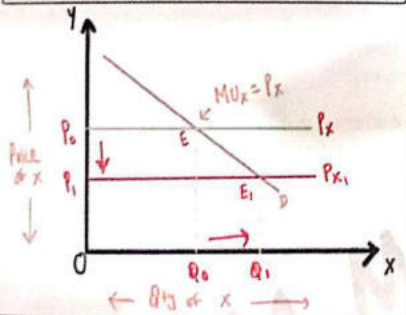
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Consumer Equilibrium in Single Commodity Case

- A consumer will be in equilibrium (will be deriving maximum satisfaction) in respect of the quantity of one good when MU = Price.
- A consumer will go on buying a good till MU = Price
- At equilibrium marginal utility of money spent on X →

$$MUm = MUx / Px = 1$$



When price falls→ Buy more of good
When price rises→ Buy less
so as to equate the marginal utility to price.

Thus, we can say that downward sloping demand curve is directly derived from marginal utility curve.

Law of Equi-Marginal Utility

- When consumer spends his income on more than 1 good→ then consumer equilibrium is explained with Law of Equi-Marginal utility.
- Consumer will be in equilibrium → spending money in such a way that MU of each good is proportional to its price & last rupee spent on each commodity yields him equal MU.

$$(MUx / Px) = (MUy / Py) = MUm$$

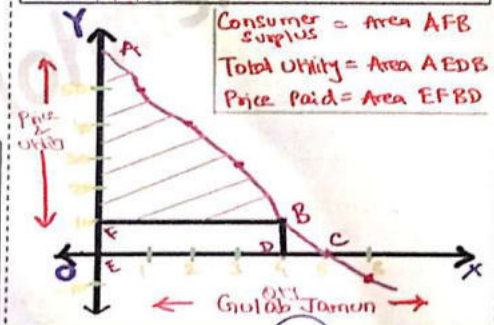
or

$$(MUx / MUy) = (Px / Py)$$

Consumer Surplus (CS)

Alfred Marshall gave concept of CS.

CS = what consumer is ready to pay - what he actually pays OR CS = MU - Price



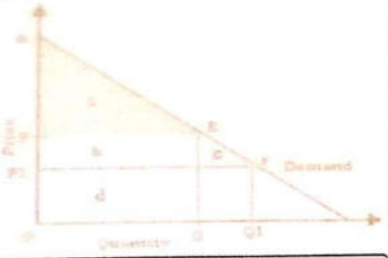
Gulab Jamun	Marginal Utility (MU) (in Utils)	Total Utility (TU) (in Utils)	Consumer Surplus
1st Piece	50	50	40
2nd Piece	40	90	30
3rd Piece	28	118	18
4th Piece	10	128	0
5th Piece	0	128	-
6th Piece	-5	123	-

- The concept of consumer's surplus is derived from the law of diminishing MU.
- Height of demand curve measures buyers willingness to pay. Difference between his willingness to pay and price that he actually pays is net gain to consumer, called the individual consumer surplus.
- Total consumer surplus in a market is sum of all individual consumer surpluses in market & is equal to area below market demand curve but above price.

Notes:

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Consumer Surplus - New Point



A fall in price from P to P1 → increases consumer surplus from APE to AP1F. Increase in CS has two components-

- ✓ Increase in CS of existing buyers (rectangle marked by "b")
- ✓ CS now available to new buyers who now started buying due to lower prices (the triangle c)

Limitations of CS

1) CS cannot be measured precisely
2) In case of necessaries→ CS is always infinite.
3) CS is affected by the availability of substitutes.
4) No simple rule for deriving utility scale of prestige goods (e.g., diamonds).
5) CS cannot be measured in terms of money → as MU of money changes as purchases are made
6) Many modern economists believe that utility cannot be measured in terms of money.

Practical Applications of CS

1) A business firm can reflect on amount of CS enjoyed by customers
2) If business can identify groups of consumers with different elasticity of demand getting different CS, then firms can profitably use price discrimination.
3) Large scale investment decisions → consider the CS which project may fetch.
4) Rising price → CS falls. Firms rising price should expect to make fewer sales.
5) CS→ guide to finance ministers → impose taxes on commodities yielding high consumer's surplus.

Notes

Ordinal Approach

- As per ordinal approach, Human satisfaction → psychological phenomenon & cannot be measured in monetary terms.
- It is easier & more sound to order preferences than to measure them in money terms.

Assumptions of Indifference Curve Analysis

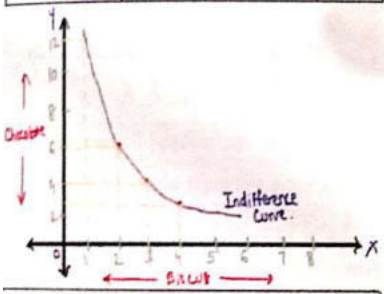
1) Consumer knows his own tastes & preferences and possesses full information
2) Consumer is rational → result in a more preferred consumption bundle over a less preferred bundle.
3) Utility is ordinally expressible. The consumer is capable of ranking all conceivable combinations (But he cannot tell quantitatively)
4) Transitive choices→ If consumer prefers combi. A to B, & B to C, then he must prefer A to C
5) If combination A has more commodities than combination B, then A must be preferred to B.

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ECONOMICS CHAPTER 2 - THEORY OF DEMAND & SUPPLY | UNIT 2 - THEORY OF CONSUMER BEHAVIOUR

Indifference Curve

Combination	Biscuit	Chocolate	MRS
A	1	12	
B	2	6	6
C	3	4	2
D	4	3	1



- An indifference curve is a curve which represents all those combinations of **two goods** which give same satisfaction to consumer.
- If a consumer equally prefers two product bundles, then consumer is indifferent between the two bundles. An Indifference curve is also called iso-utility curve or equal utility curve.

Marginal Rate Of Substitution (MRS)

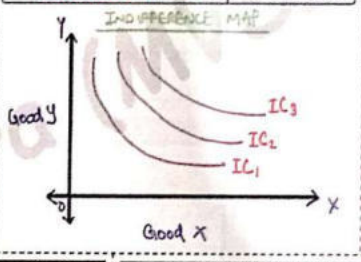
- MRS of X for Y → amount of Y whose loss can just be compensated by a unit gain of X in such a manner that the level of satisfaction remains same.
- MRS is absolute value of slope of IC ($MRS = \Delta Y / \Delta X$)
- $MRS = MUx / Muy$

Why MRS keeps falling ?

- Wants are satiable → when a consumer has more of a good, his intensity of want for it decreases.
- Most goods are imperfect substitutes of one another.

Indifference Map

- Indifference map→ collection of many indifference curves where each curve represents a certain level of satisfaction. (set of indifference curves)
- It depicts complete picture of consumer's tastes & preferences.



Notes

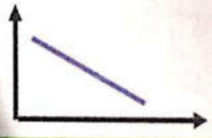
Properties of IC

1) Indifference curves slope downward to the right
2) Indifference curves are always convex to the origin (since MRS which is slope is falling)
3) Indifference curves can never intersect each other
4) A higher indifference curve represents a higher level of satisfaction
5) Indifference curve will not touch either axes

Indifference Curve in case of

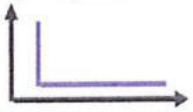
Substitute Goods

- Downward Sloping
- Straight Line
- MRS is constant



Complementary Goods

- L-shaped
- Convex to origin
- 2 straight lines with right angle bent



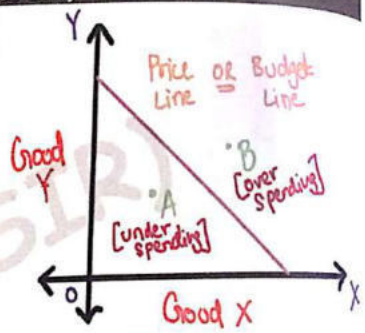
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Budget Constraint

- A consumer → to maximise satisfaction → will try to reach highest possible indifference curve.
- But, in his pursuit of maximizing satisfaction, he has to work under two constraints:
  1) Pay prices for goods &,
  2) Has a limited money income
  Thus, a consumer's choices are limited by the budget available.
- Algebraically, budget constraint for two goods X and Y as → $[P_xQ_x + P_yQ_y] \leq B$

Budget Line (aka. Price Line)

- Budget constraint → explained by budget line
A budget line shows all those combinations of two goods which consumer can buy spending his given money income on the two goods at their given prices.
  - ❑ Any point on the BL → spends all his money income
  - ❑ Any point above BL (point B) → over-spending (beyond reach)
  - ❑ Any point within (below) BL (point A) → under spending

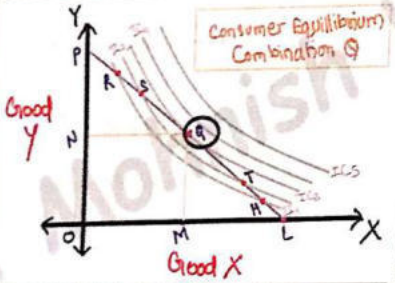


- Slope of budget line = 'Price Ratio' = P_x / P_y
- The budget line will shift when there is:
  - ❑ A change in prices of one or both goods
  - ❑ A change in level of nominal income
  - ❑ A change in both income and relative prices

Consumer's Equilibrium

Consumer is in equilibrium → deriving maximum possible satisfaction from goods & thus is in no position to rearrange his purchases of goods.

Here we assume that:
- Consumer has a given indifference map
- He has a fixed money income
- Prices of goods X and Y are given and fixed.
- Goods are homogeneous & divisible, and
- Consumer acts 'rationally' & maximizes satisfaction.



A consumer's optimal choice should satisfy two criteria→ Equi. point should
- Be a point on his budget line; &
- Lie on highest indifference curve possible

Consumer is in equilibrium at 'Combination Q', where budget line PL is tangent to indifference curve IC3

At equilibrium point,
Slope of IC = Slope of BL
[MUx/Muy] = [Px/Py]

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IC Analysis Vs Utility Analysis

IC analysis is superior to utility analysis:
1) No assumption of measurability of utility
2) Studies more than one commodity at a time
3) Does not assume constancy of MU of money
4) Segregates income effect from substitution effect.

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Introduction

- Demand → Consumer point of view
- Supply → Seller point of view (Sellers can be individuals, firms & governments)

- 'Supply' refers to amount of G/S that producers are
  - willing and
  - able to offer to the market
  - at various prices
  - during a given period of time.

- Three important things about supply
1) Supply→ what a firm offer for sale→ not necessarily to what they succeed in selling.
2) Supply is a flow concept→ 'so much' per unit of time
3) Supply requires → willingness & ability to supply.

Determinants of Supply

1) Price of the good
Ceterus paribus, price increases → supply increases (since profit increase) & vice versa

2) Price of related goods
If a farmer produces & sells wheat and soya. If price of wheat rises, farmer may shift his land to wheat production away from soya (decreasing supply of soya)

3) Prices of factors of production
Rise in price of factors of prod. → increase in cost of prod. → profit decreases → supply decreases

4) State of technology
Use of advanced tech→ low cost→ supply increases

5) Government Policy
- Increase in Taxes→ cost rises→ supply decrease
- Increase in Subsidy→ cost falls→ supply increase
- Restrictions→ import quota or rationing on inputs→ production fall→ supply decrease

6) Number of sellers, Nature of competition and size of industry
No. of sellers rise→ Competition increase→ More supply and vice versa.

8) Expectations
An increase in anticipated future price → reduces its supply today

9) Other Factors
- government policies,
- goals of firm,
- infrastructural facilities,
- natural factors → weather, floods, earthquake
- man-made factors → war, labour strikes, communal riots etc.

Law of Supply

- Other things remaining constant, quantity supply will increase as price rises and vice versa.
- The behaviour of supply is affected by the time taken into consideration-
  - In short run→ not easy to increase supply,
  - In long run→ can be easily adjusted in response to changes in price.
- Law of supply→ explained through supply schedule & supply curve.

Supply Schedule

Tabular presentation of law of supply

	Price (Rs)	Qty Supplied (in units)
A	2	10
B	4	20
C	6	35
D	8	60
E	10	80

Notes:

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Supply Curve

A supply curve is the graphical presentation of supply schedule. Here price is plotted on the Y-axis & quantity supplied on the X-axis.



- Supply curve depicts direct relation between price & qty supplied → thus it is upward sloping.
- Supply curve shows simultaneously:
  - highest quantity willingly supplied by the suppliers at each price &
  - minimum price which will induce suppliers to offer the various quantities for sale

- Market supply→ sum of supplies of a commodity made by all sellers in a market
- Market supply curve→ Obtained by adding horizontally the supply curves of various firms.

Changes in Supply vs Quantity Supplied

Supply	Quantity Supplied
Supply refers to entire relationship between price & quantity supplied.	Quantity supplied is the quantity which is supplied at a specific price.
Represented by entire supply schedule & curve.	It is represented by a point on the supply curve.
"Changes in Supply" occur due to changes in factors other than price of good.	"Changes in Quantity Supplied" occur due to changes in price of goods concerned.

Favourable change in any factor other than price	Unfavourable change in any factor other than price	Increase in price of goods concerned	Decrease in price of goods concerned
Increase in Supply → Rightward shift in supply curve Eg- Decrease in price of related good, Advance tech, fall in tax etc.	Decrease in Supply → Leftward shift in supply curve Eg- Increase in price of related good, Govt restriction, fall in tax etc.	Expansion or Extension of Supply → Upward movement along the same supply curve	Contraction of Supply → Downward movement along the same supply curve

Notes

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Elasticity of Supply

Elasticity of supply → Responsiveness of quantity supplied of a good to a change in its price.

Percentage Method

$$\frac{\%\ \Delta Qs}{\%\ \Delta P}$$

OR

$$\frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

OR

$$\frac{1}{\text{Slope}} \times \frac{P}{Q}$$

Point Method

$$\frac{dQ}{dP} \times \frac{P}{Q}$$

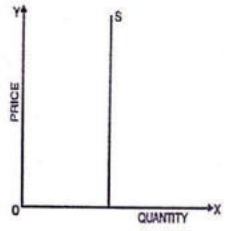
Where, dQ/dP = Derivative of qty with respect to a point on supply curve

Arc Method

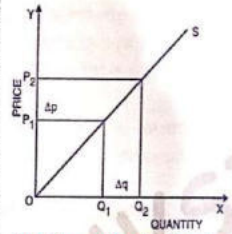
$$\frac{Q2 - Q1}{Q2 + Q1} \times \frac{P2 + P1}{P2 - P1}$$

- Value of price elasticity of supply is always positive, since price & qty supplied have direct (positive) relation
- When no method is specified in question → use percentage method.
- Use point method
  - When price change is infinitesimal small,
  - When data of Qty supplied is given as an equation
- When price elasticity is to be calculated between two points → use arc method.

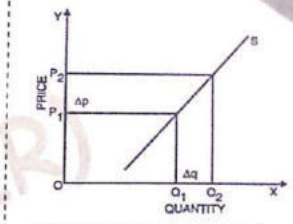
Interpretation of Values of Elasticity of Supply



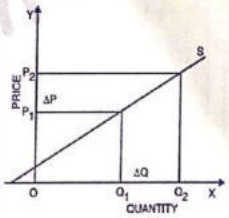
- Perfectly inelastic supply
- Es = 0
- Vertical Supply Curve
- Parallel to Y-axis or Price axis
- When price changes → %ΔQ = 0



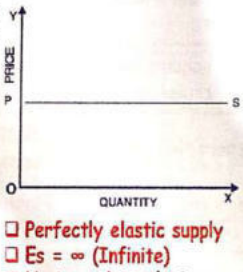
- Unitary Elastic Supply
- Ep = 1
- Supply Curve→ passes through origin (irrespective of degree with X axis)
- %ΔQ = %ΔP



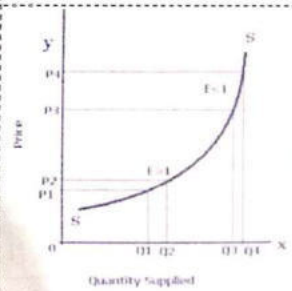
- Relatively inelastic supply
- Es < 1
- Steeper Supply Curve
- %ΔQs < %ΔP



- Relatively elastic supply (Es > 1)
- Flatter Supply Curve
- %ΔQs > %ΔP



- Perfectly elastic supply
- Es = ∞ (Infinite)
- Horizontal Supply Curve
- Parallel to X-axis or qty axis
- Small increase in price causes supply to rise from zero to an infinitely



If firms have-

- Idle capacity→ elastic supply
- Reached their full capacity→ inelastic demand

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How to improve price elasticity of supply ?

A business organization generally tries to keep their price elasticity of supply high as they want to earn more profit when prices rise, or shorten their production when price fall.

To improve price elasticity of supply an organsation can-
- ❑ Improve the technology used, such as upgrading equipment
- ❑ Improve production capacity
- ❑ expanding storage space for stock while making sure that products can last long while stored.

Determinants of Elasticity of Supply

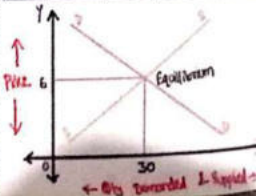
1.	Increase in Production → substantial cost increase → Profit decrease	Inelastic Supply
	Increase in Production → negligible rise in cost or constant cost	Elastic Supply
	Complex production process → require long time to produce (Eg- aircraft, cruise ship)	Inelastic Supply
2.	If after increase in price → short time period	Inelastic Supply
	If after increase in price → long time period → build new plants or new firms	Elastic Supply
3.	More no. of sellers → More competition → Fewer barriers to entry	Elastic Supply
4.	Not working on full capacity → more spare capacity	Elastic Supply
5.	Key raw material → easily & cheaply available	Elastic Supply
	Procuring resources is difficult or costly	Inelastic Supply
6.	Raw material & finished goods → easily & cheaply stored → have adequate stock	Elastic Supply
7.	Sellers expect → rise in future price	Inelastic Supply
8.	Inputs → Short in supply → require longer delivery period → highly specialized nature	Inelastic Supply
9.	Labour → highly skilled → scarce → require longer training period	Inelastic Supply
10.	Capital & labour → occupationally mobile	Elastic Supply
	Products continuously produced	Elastic Supply
	Products infrequently produced	Inelastic Supply

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Equilibrium Price

- Market Equilibrium is a market situation where, Qty dem = Qty supplied
- Intersection of demand & supply determines equilibrium price (aka market clearing price)
- Determination of market price is central theme of micro economic analysis. Thus, micro-economic theory → aka. price theory.

P	Qd	Qs	Impact on Price
8	15	52	Downward
6	30	30	Equilibrium
3	40	18	Upward



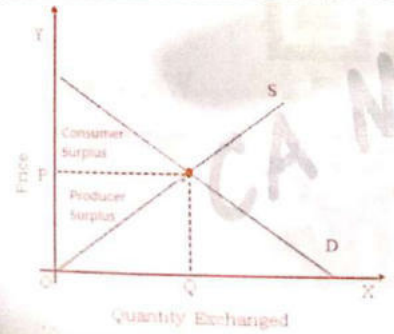
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Social Efficiency

- **Social efficiency** represents net gains to society from all exchanges that are made in a particular market. It is achieved when both producers & consumers enjoying maximum possible surplus.

- **Consumer surplus** → measure of consumer welfare. [MU - Price]
  - It is represented by area below demand curve & above price line

- **Producer surplus** → benefit derived by producers from the sale of a unit above & beyond their cost of producing that unit. [SP - Cost]
  - It is represented by area above supply curve & below price line.



Notes

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CA Foundation - New Syllabus

Business Economics - Paper 4

SUPER CHART BOOK by MVSIR

Chapter 3

Theory of Production & Cost

(Weightage: 10 Marks)

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ECONOMICS CHAPTER 3 - UNIT 1 - THEORY OF PRODUCTION

Basics

As per Economics, production denotes process by which man utilises resources to transform them into goods and services to make them satisfy human wants. (similar definition given by James Bates and J.R. Parkinson)

The performance of an economy is judged by level of its production.

Production can also be defined as creation or addition of utility. During production we can confer 4 types of utility-

1) **Form Utility-** Changing form of things to add utility to it. Eg- Wood to chair.
2) **Place Utility-** Changing place of resources from a place where they are of little or no use to another place where they are of greater use. Eg- extraction of minerals from earth, apple from Kashmir to Mumbai etc.
3) **Time Utility-** Making available materials at times when they are not normally available. Eg- Canning of seasonal fruits
4) **Personal Utility-** Making use of personal skills in the form of services, e.g., those of organisers, merchants, transport workers etc

Production does not include work done within a household by anyone out of love and affection, voluntary services and goods produced for self consumption. Eg- Food made by mother in home is NOT production

Factors of Production (Inputs)

An input is a good or service which a firm buys for use in its production process.

- Natural Resources
  - 1) Land → Primary or original factor
  - 2) Labour → Primary or original factor
- Human Endeavour
  - 3) Capital → Produced factor, as it is produced by man
  - 4) Entrepreneur → Produced factor, as it is produced by man

Land

It refers to soil or earth's surface and to all free gifts of nature which would include all natural resources, soil, water, air, light, etc.

Characteristics

1) Land is a free gift of nature
2) Supply of land is fixed
Supply of land is perfectly inelastic from view of economy And relatively elastic from the point of view of a firm
3) Land is permanent and has indestructible powers
4) Land is a passive factor
5) Land is immobile
6) Land has multiple uses
7) Land is heterogeneous

Labour

It refers to various types of human efforts which require use of physical exertion, skill and intellect.

Labour must be done with motive of economic reward. Anything done out of love and affection or for sake of pleasure or love, is not labour

Characteristics

- Labour is perishable, requires human effort, active factor, inseparable from labourer, mobile.
- Labour power differs from labourer to labourer
- Labour has poor bargaining power
- Supply of labour cannot be increased or decreased instantly
- Supply curve of labour has backward bending shape

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ECONOMICS CHAPTER 3 - UNIT 1 - THEORY OF PRODUCTION

Capital

Capital is 'produced means of production' or 'man-made instruments of production'. It refers to all man made goods (assets) that are a part of wealth (total assets) and are used for further production of wealth.

Produced factor, as it is produced by man by working with nature.

Eg- Machine tools and instruments, factories, etc.

Capital is a stock concept which yields a periodical income which is a flow concept

Types of Capital

1) **Fixed capital** - Durable nature & renders services over a period of time
2) **Circulating capital** - For single use and is not available for further use. Eg, seeds, fuel, raw materials etc
3) **Real (Tangible) capital** - Physical goods (can be perceived by senses)
4) **Intangible Captial** - rights & benefits which cannot be perceived by senses. Eg- patents, goodwill etc.
5) **Human capital** - Human skill and ability
6) **Individual capital** - Personal property
7) **Social capital** - Belongs to society as a whole in form of roads, bridges, etc.

Capital Formation (aka Investment)

Capital formation means a sustained increase in the stock of real capital in a country.

It involves production of more capital goods like, machines, factories, etc. which are used for further production of other goods.

Stages of Capital Formation

1) Savings
2) Mobilisation of savings
3) Investment

Entrepreneur

Entrepreneur is a factor which

- mobilises other factors of production,
- combines them in right proportion,
- initiates process of production and bears risks involved in it.

Functions of Entrepreneur

1) **Initiating business** enterprise and resource co-ordination

2) **Risk bearing** or uncertainty bearing
Financial risks & Technological risks, Profit is reward, risk bearing cannot be delegated

3) **Innovations** - Most Important Function

Enterprise Objectives

1) Organic objectives
2) Economic objective
3) Social objectives
4) Human objectives
To provide fair deal to employees etc
5) National objective

Enterprise Problems

1) Objectives
2) Location & size of the plant
3) Selecting & organising physical facilities
4) Finance
5) Org. structure
6) Marketing
7) Legal formalities
8) Industrial Relations

Production Function

Production function is a mathematical statement of relationship between dependent variable (output) and independent variable (inputs). [similar definition given by Samuelson]

$$Q = f(\text{Labour}, \text{Capital}) = f(L,K)$$

Assumptions of Production Function

1) Relationship between inputs and outputs exists for a specific period of time

2) Production technology remains constant

3) Output resulting from use of inputs is at the maximum level (no wastage)

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Short Run Production Function

Short-run production function shows maximum amount of a good or service that can be produced by set of inputs, assuming that amount of at least one of inputs used remains unchanged.

In short run, Capital is fixed and Labour is variable.

It is the subject matter of the law of variable proportion

Long Run Production Function

A long run production function shows maximum quantity of a good or service that can be produced by set of inputs, assuming that all inputs are variable

It is the subject matter of the law of returns to scale.

Law of Variable Proportions

Aka. Law of returns to a variable input OR Law of diminishing returns

Law states that as we increase quantity of one input (Labour) which is combined with other fixed inputs, marginal product (MP) of the variable input must eventually decline.

Assumptions of Law of Variable Proportions

1) Production technology remains constant
2) Must be some inputs which are fixed (Short Run)
3) Law does not apply where factors must be used in fixed proportions to yield output
4) Consider only physical inputs and outputs (unit terms) and not in monetary terms

TP vs AP vs MP

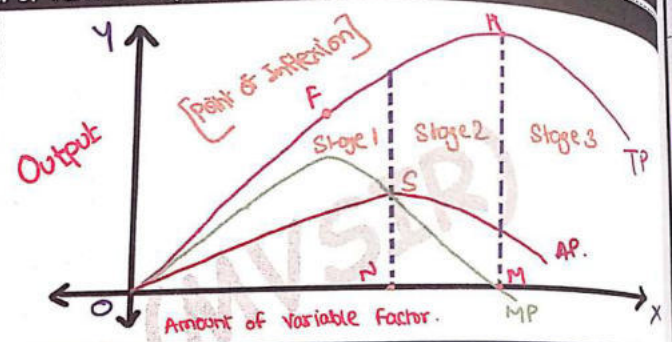
Total Product (TP) : Total output resulting from efforts of all factors of production combined together at any time

Average Product (AP) : Total product per unit of the variable factor.

AP = TP / No. of Units of Variable Factor

Marginal Product (MP) : Change in TP per unit change in quantity of variable factor.

MP = ΔTP / ΔQ



	Stages	TP	MP	AP
1	Increasing Returns	TP increases at increasing rate till POI After POI, TP increases with decreasing rate.	MP rises & is maximum corresponding to POI, and the falls. MP > AP, throughout.	AP is rising. Stage ends= AP is max & AP = MP
2	Diminishing Returns	TP increases with decreasing rate Stage ends= TP is max.	MP is decreasing but positive. Stage ends= MP is 0 MP < AP, throughout.	AP is decreasing but positive.
3	Negative Returns	TP is decreasing	MP is decreasing & negative.	AP is decreasing but positive.

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ECONOMICS CHAPTER 3 - UNIT 1 - THEORY OF PRODUCTION

Law of Variable Proportions – Production Schedule

Quantity of labour	Total Product (TP)	Average Product (AP)	Marginal Product (MP)	Stages
1	100	100	100	Stage 1
2	210	105	110	
3	330	110	120	
4	440	110	110	
5	520	104	80	Stage 2
6	600	100	80	
7	670	95.70	70	
8	720	90	50	
9	750	83.30	30	
10	750	75	0	
11	740	67.30	-10	Stage 3

Relationship between AP & MP

- When AP rises → MP > AP
- When AP is maximum → MP = AP
- When AP falls → MP < AP

Stage of Operation

- Never produce in Stage 1 & 3 are → 'economic absurdity' or 'economic non-sense'
- Rational producer→ Produce in stage 2

Returns to Scale

Occurs in LONG RUN

A change in scale means that all factors of production are increased or decreased in same proportion.

The study of changes in output as a consequence of changes in scale forms subject matter of returns to scale.

Eg- When ALL inputs are increased by 40%

- **Constant Returns to Scale (CRS)**
  % Increase in Output = % Increase in Input
  Eg; If output increases by 40%, then it is CRS

  CRS is also referred to as "Linear Homogeneous Production Function"

- **Increasing Returns to Scale (IRS)**
  % Increase in Output > % Increase in Input
  Eg; If output increases by 70%, then it is IRS

- **Decreasing Returns to Scale (DRS)**
  % Increase in Output < % Increase in Input
  Eg; If output increases by 35%, then it is DRS

Cobb-Douglas Production Function

This function applies not to an individual firm but to whole of manufacturing industry.

Labour contributed about 3/4th and capital about 1/4th of increase in production

$$Q = K.\ L^a.\ C^b$$

Where 'Q' is output, 'L' the quantity of labour and 'C' the quantity of capital, 'K' and 'a' and 'b' are positive constants.

- $a + b > 1$, Increasing returns to scale
- $a + b = 1$, Constant returns to scale
- $a + b < 1$, decreasing returns to scale

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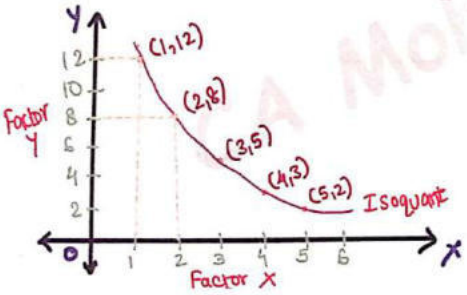
ECONOMICS CHAPTER 3 - UNIT 1 - THEORY OF PRODUCTION

Isoquants

An isoquant represents all those combinations of inputs which can produce the same level of output.

Isoquants are aka : equal-product curves, production indifference curves or iso-product curves.

Factor combination	Factor X	Factor Y	MRTS
A	1	12	-
B	2	8	4
C	3	5	3
D	4	3	2
E	5	2	1



Properties of Isoquants-

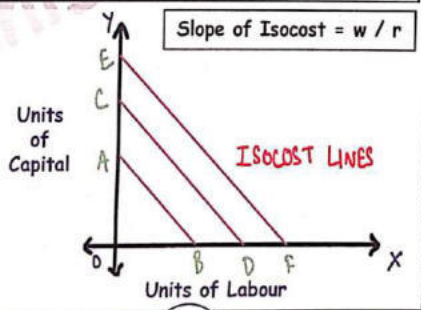
- Negatively sloped, (Slope of Isoquant = MRTS)
- Convex to the origin due to diminishing MRTS
- Curve on right represents a higher level of output,
- non intersecting.

However, one important difference between isoquant & indifference curve is that in an

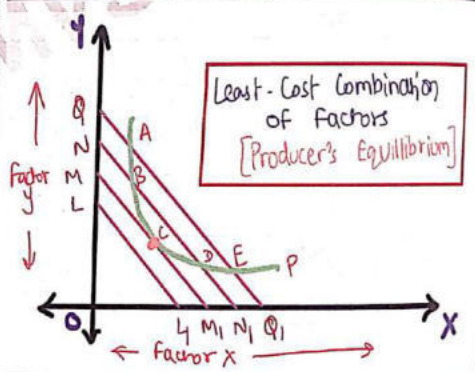
- Isoquant - level of production is easily quantified whereas,
- In an indifference curve it is not possible to quantify the level of satisfaction acquired by the consumer.

Isocost

- Isocost line, aka. Equal-Cost Line or budget line or budget constraint line,
- It shows various alternative combinations of two factors which the firm can buy with given outlay.
- Whatever be the combination of factors the firm chooses on isocost line, the total cost to firm remains the same.



Producer Equilibrium



A producer can produce the desired output at least possible cost at equilibrium.

Producer equilibrium will be achieved where isocost line is TANGENT to isoquant (at point C)

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ECONOMICS CHAPTER 3 - UNIT 2 - THEORY OF COST

Cost Analysis

Cost analysis is concerned with the financial aspects of production relations as against physical aspects which were considered in production analysis.

Cost Concepts

1) Accounting Costs & Economic Costs

Accounting (Explicit or Outlay) costs are expenses which will have to be incurred by firm and are recorded in financial statements.

Economic Cost = Explicit + Implicit Cost

Implicit Cost is cost of using self owned factors. Eg- normal return on capital invested by owner himself in his business; salary not paid to entrepreneur which could have been earned elsewhere

2) Outlay costs & Opportunity costs

Outlay costs involve actual expenditure

Opportunity cost is the cost of next best alternative opportunity which was foregone to pursue certain action. It is cost of the missed opportunity

Cost Concepts

3) Traceable (Direct) costs & Non-Traceable (Indirect) costs

Direct costs are costs that are readily identified and are traceable to a particular product, operation or plant

Indirect costs are those which are not easily and definitely identifiable in relation to a plant, product, process or department. Eg- Electricity exp, common or general exp etc.

4) Incremental costs & Sunk costs

Incremental cost refers to the additional cost incurred by a firm as result of a business decision

Sunk Costs are costs which are already incurred once and for all and cannot be recovered. They are based on past commitments and cannot be revised or reversed if the firm wishes to do so.

5) Historical costs & Replacement costs

Historical cost refers to the cost incurred in the past on the acquisition of a productive asset such as machinery etc

Replacement cost is the money expenditure that has to be incurred for replacing an old asset

6) Private costs & Social costs

Private costs are costs actually incurred or provided for by firms and are either explicit or implicit

Social cost refers to the total cost borne by the society on account of a business activity and includes private cost and external cost

7) Fixed Costs & Variable costs

- Fixed or constant costs are costs which do not vary with output upto a certain level of activity.
  - These require fixed expenditure of funds irrespective of level of output, e.g., rent, property taxes, interest on loans etc
  - Fixed cost is a function of capacity
  - If the firm closes down for some time in the short run but remains in business, fixed cost CANNOT be avoided (inescapable)
  - Shut down costs are costs which will continue even after operations are suspended. Eg- for storing of old machines which cannot be sold in market.
- Variable Costs (VC) are costs which vary with the level of output (function of output)
  - If a firm shuts down for a short period, then VC can be avoided
  - Eg- wages of labour, prices of raw material, fuel, transportation cost etc

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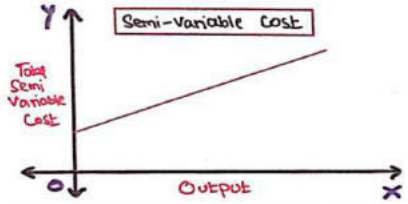
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Cost Concepts

8) Semi - Variable Cost

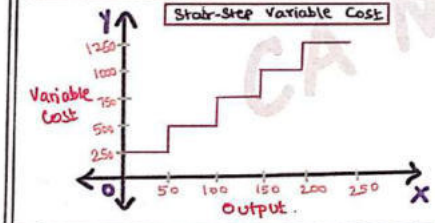
Some costs which are neither perfectly variable, nor absolutely fixed in relation to the changes in the size of output.

Eg: Electricity exp, Postpaid Phone Bill etc



9) Stair-Step Variable Cost

Some costs which may increase in a stair-step fashion, i.e., they remain fixed over certain range of output; but suddenly jump to new higher level when output goes beyond a given limit.



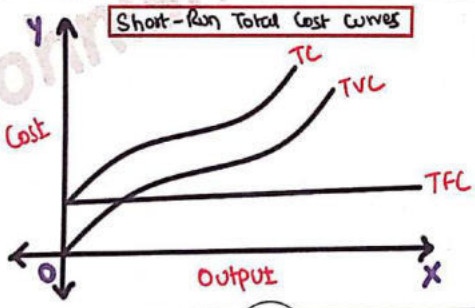
Short Run Total Costs

- TC = TFC + TVC

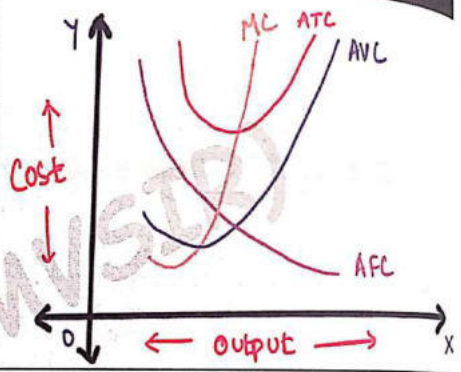
Total Fixed Cost curve (TFC)
- horizontal straight line parallel to X-axis
- Starts from a point on the Y-axis

Total Variable Cost (TVC)
- Initially increases at a decreasing rate and then at an increasing rate. (Inverted-S shaped)

Total Cost Curve (TC)
- Obtained by adding vertically the TFC curve and the TVC curve.
- Slopes of TC & TVC are same (Inverted-S shaped)
- At each point the TC & TVC curves have vertical distance equal to total fixed cost.



Short Run Average Costs



Average Fixed Cost curve (AFC)
- AFC = TFC / Q
- AFC is fixed cost per unit of output.
- AFC falls as output increases.
- AFC curve will slope downwards throughout its length but will not touch the X-axis as AFC cannot be zero. (shape- rectangular hyperbola)

Average Variable Cost (AVC)
- AVC = TVC / Q
- AVC curve will first fall, then reach a minimum and then rise (U-shaped)

Average Total Cost (ATC or AC)
- ATC = TC / Q or ATC = AFC + AVC
- ATC curve will first fall, then reach a minimum and then rise (U-shaped)

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ECONOMICS CHAPTER 3 - UNIT 2 - THEORY OF COST

Units of output	Total fixed cost	Total variable cost	Total cost	Average fixed cost	Average variable cost	Average total cost	Marginal cost
0	1000	0	1000	-	-	-	-
1	1000	50	1050	1000.00	50.00	1050.00	50
2	1000	90	1090	500.00	45.00	545.00	40
3	1000	140	1140	333.33	46.67	380.00	50
4	1000	196	1196	250.00	49.00	299.00	56
5	1000	255	1255	200.00	51.00	251.00	59
6	1000	325	1325	166.67	54.17	220.83	70
7	1000	400	1400	142.86	57.14	200.00	75
8	1000	480	1480	125.00	60.00	185.00	80
9	1000	570	1570	111.11	63.33	174.44	90
10	1000	670	1670	100.00	67.00	167.00	100
11	1000	780	1780	90.91	70.91	161.82	110
12	1000	1080	2080	83.33	90.00	173.33	300

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Marginal Cost Curve (MC)

Marginal cost is addition made to total cost by production of an additional unit of output.

MC = Δ in TC / Δ in Output
Or
MC = Δ in TVC / Δ in Output

MC is independent of fixed cost.

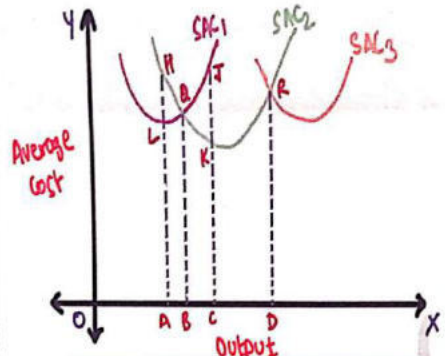
The value of MC comes due to the changes in variable costs.

MC curve becomes minimum corresponding to the point of inflection on the total cost curve

MC curve declines first, reaches its minimum and then rises ("U" shaped)

MC Curve intersects AC curve and AVC curve at their respective minimum points.

MC & AC	MC & AVC
AC falls → MC < AC	AVC falls → MC < AVC
AC rises → MC > AC	AVC rises → MC > AVC
AC min. → MC = AC	AVC min. → MC = AVC



SHORT RUN AVERAGE COST CURVES

How to select a Short Run Avergae Cost Curve (SAC Curve) in the long run ?

SAC Curve is aka. PLANT Curves

As per above figure,

- For making output upto OB - use SAC 1
- For output more than OB, but less than OD - use SAC 2
- For output more than OD - use SAC 3

Long Run Average Cost Curve

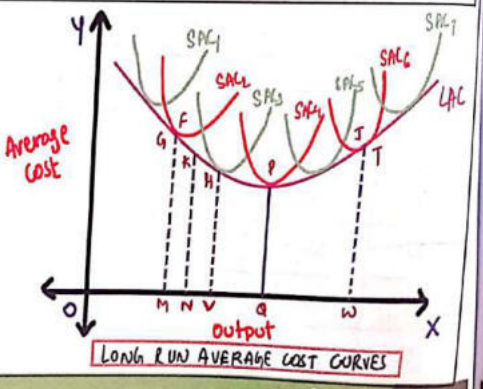
Long run is a period during which firm can vary all its inputs (Labour & Capital both)

In the long run the firm can build any size or scale of plant and therefore, can move from one plant to another. Long run is planning horizon.

A firm plans for the long run and operates in short run.

Long run cost of production is the least possible cost of producing any given level of output when all individual factors are variable.

Long run cost curve depicts functional relationship between output and long run cost of prod.



LONG RUN AVERAGE COST CURVES

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ECONOMICS CHAPTER 3 - UNIT 2 - THEORY OF COST

Long Run Average Cost Curve

LAC Curve is aka. Planning Curve or Envelope Curve or Boat Curve

LAC Curve is drawn so as to be tangent to each of the SAC curves

However, LAC curve is NOT tangent to minimum points of SAC curves

- When LAC curve is declining, it is tangent to falling portions of SAC curves and
- When LAC curve is rising, it is tangent to rising portions of SAC curves

"OQ" is the optimum output. This is because "OQ" is being produced at minimum point of LAC and corresponding SAC 4 (as per graph). Production ot OQ is done at FULL CAPACITY.

For producing output less than "OQ", firm will construct relevant plant and operate it at less than its full capacity.

Whereas for outputs larger than OQ the firm will construct a plant and operate it beyond its optimum capacity.

The falling portion (negatively sloped) region of LAC curve is due- Increasing Returns to Scale and Economies of Scale

The rising portion (positively sloped) region of LAC curve is due- Decreasing Returns to Scale and Diseconomies of Scale

SCALE OF PRODUCTION

Economies of scale are cost advantages that enterprises obtain due to their scale of operation, with cost per unit of output decreasing which causes scale increasing.

Internal Economies

Internal economies accrue to firm when it expands its output, so that cost of production would come down.

Internal economies arise purely due to endogenous (internal) factors

Internal Economies and Diseconomies

1) Technical
2) Managerial
3) Commercial
4) Financial
5) Risk bearing

External Economies

External economies are benefits accruing to each member firm of the industry as a result of expansion of the industry.

They are not dependent on the output level of individual firms.

External Economies and Diseconomies

1) Cheaper raw materials & equipment
2) Technological external economies
3) Development of skilled labour
4) Growth of ancillary industries
5) Better transportation & marketing
6) Economies of Information

- However, external economies may cease if there are certain disadvantages which may neutralise the advantages of expansion of an industry. External diseconomies are disadvantages that originate outside firm, like in input markets.
- Eg- Rise in various factor prices. When an industry expands, demand of factors (inputs) increases, leading to in increase in prices of factors, especially when they are short in supply.
- Moreover, too many firms in an industry at one place may also result in higher transportation cost, marketing cost and high pollution control cost.
- Government may also, through its location policy, restrict expansion of an industry.

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CA Foundation - New Syllabus

Business Economics - Paper 4

SUPER CHART BOOK by MVSIR

Chapter 4

Price Determination In Different Markets

(Weightage: 15 Marks)

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ECONOMICS CHAPTER 4 - PRICE DETERMINATION IN DIFFERENT MARKETS | UNIT 1 - MEANING AND TYPES OF MARKETS

From where does the concept of price arises ?

Free Goods - These goods are free or have zero prices. They are abundant in supply thus do not have scarcity. Example: air, sunlight etc

Economic Goods - They are scarce in relation to their demand and have an opportunity cost. They are exchangeable in the market and command a price Eg clothes, mobile phone etc

Price signifies the quantity of money necessary to acquire a good or service. It is the money-value i.e. the purchasing power of an article expressed in terms of money.

Value in exchange or exchange value, according to Ricardo, means command over commodities in general, or power in exchange over purchasable commodities in general.

'Value in Use' and 'Value in Exchange'

Value in use refers to usefulness or utility i.e, attribute which a thing has to satisfy human needs

Value in exchange or economic value is amount of goods and services which we may obtained in market in exchange of a particular thing.

In Economics, we are only concerned with exchange value. Considerations such as sentimental value is not considered in a market economy, as it is subjective.

Meaning of Market

Exchange value is determined in the market where exchange of goods and services takes place

A market is a collection of buyers and sellers with the potential to trade.

A market need not be formal or held in a particular place. Eg- 2nd hand goods are often sold through listing it in an online websites. (OLX, Quikr etc)

Elements of Markets

1) Buyers and sellers;
2) A product or service;
3) Bargaining for a price;
4) Knowledge about market conditions; (rational buyers & sellers) and
5) One price for a product/service at a given time.

Classification of Markets

I) General Classification

a) Factor Market - Market in which firms buy the resources (inputs) to produce G/S. They allocate productive resources to producers. Prices in factor markets - factor prices.

b) Product Markets - Markets in which households buy G/S they want from firms. They allocate goods to consumers.

II) Geographical Area Classification

a) Local Market - Here buyers and sellers are limited to a local area or region,
Highly perishable goods and bulky articles, (transport of over long distance is uneconomical) are sold here.
Also it is limited to a particular locality.
Eg- locally supplied services - hair dressers & retailers.

b) Regional Market - They cover a wider area such as a few adjacent cities, parts of states etc.
Eg- Mekhela Chador (Assamese Saree), Yewle Tea etc.

c) National Markets - When demand is limited to national boundaries of a country.
The trade policy of government may restrict trading of a commodity to within country.
Eg- Hindi books - national markets in India.

d) International Markets - High value & small bulk commodities are demanded and traded internationally.
Eg- Gold and Silver.

Above classification has become outdated as in modern days even perishable goods have international market.

III) Regulation

a) Regulated Market - Here transactions are statutorily regulated, to put an end to unfair practices.
Eg. Stock exchange

b) Unregulated Market - Aka. free market - no stipulations on transactions. Eg- Weekly (Haat) Baazaars.

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IV) Time

Alfred Marshall conceived the 'Time' element in markets

a) **Very Short Period Market** – Aka. Market period -here supply is fixed - cannot be increased or decreased.
Eg- perishable goods- vegetables,, fish, milk, etc
Since supply is fixed, very short period price is dependent on demand. An increase in demand will raise the prices vice versa.

b) **Short Period Market** – Slightly longer than very short period.
Here, supply can be moderately adjusted.

c) **Long-period Market** – In long period, all factors become variable and supply can be fully adjusted to changes in demand by altering scale of production.
The interaction between long run supply and demand determines long run equilibrium price or 'normal price'.

d) **Very long-period Market** – Aka. secular period

V) Nature of Transaction

a) **Spot / cash Market**- Goods are exchanged for money payable either immediately or within short span of time

b) **Forward or Future Market**- Transactions involve contracts with a promise to pay and deliver goods at some future date

VI) Volume of Business

a) **Wholesale Market**- Goods are sold in bulk or large quantities. Transactions between traders

b) **Retail Market**- Goods are sold in small quantities. This is the market for ultimate consumers.

VII) Competition

Assumptions	Market Types			
	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Number of Sellers	Very Large	Large	Small Numbers	One
Product Differentiation	None	Slight	None to substantial	Extreme
Price Elasticity of Demand of firm	Infinite	Large	Small	Small
Degree of control over price	None	Some	Some	Very Considerable

Concepts Of TR, AR & MR

I) Total Revenue (TR)

The amount of money which a firm realises by selling a commodity. [TR = P × Q]

II) Average Revenue (AR)

AR is revenue earned per unit of output.
AR = Price = TR / Q
Also, AR curve = Demand Curve of firm

III) Marginal Revenue (MR)

MR is change in TR resulting from sale of an additional unit of commodity. (MR is slope of TR)
MR = ΔTR / ΔQ or MRn = TR n - TR n-1
or MR = dTR / dQ

AR = Price → Happens in ALL types of market

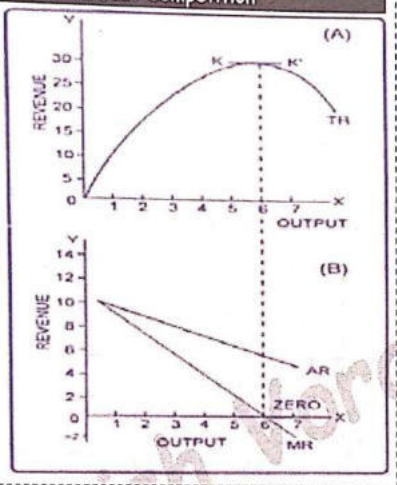
AR = Price = MR→ ONLY in Perfect Comp.

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Concepts of TR, AR & MR in Imperfect & Perfect Competition

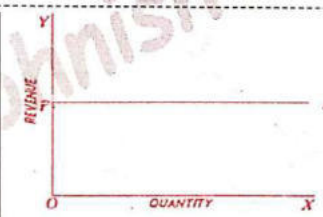
For any falling average revenue (or price) schedule, (in Imperfect Competition)

- AR curve slopes downwards (inverse relationship between price and qty dem)
- MR < AR → MR declines more rapidly than AR → because any reduction in price applies to all units sold.
- TR increases when MR is positive & TR declines when MR is negative.
- TR initially increases at diminishing rate due to diminishing MR and reaches maximum & then it falls. (Inverted U shaped)
- When MR becomes zero, the TR is maximum, slope of TR is 0



For constant average revenue (or price) schedule (in Perfect Competition)

- MR = AR = Price
- AR Curve = Demand Curve = MR Curve → Horizontal straight line parallel to X axis → Perfectly elastic demand (Ep = ∞)
- TR will be upward sloping straight line



AR and MR Curves under Perfect Competition

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Relationship → AR, MR, TR & Price Elasticity of Demand

$$MR = AR \times \frac{e - 1}{e}$$

Portion of Demand Curve	Value of e	MR	TR
Mid Point	e = 1	MR = 0	TR → maximum
Upper	e > 1	MR → positive	TR → Rising
Lower	e < 1	MR → negative	TR → Falling

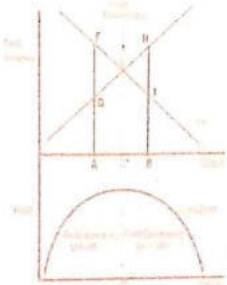
Behavioural Principles

Principle 1

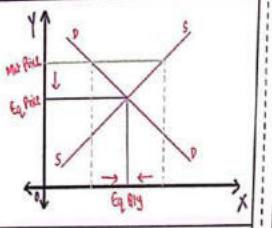
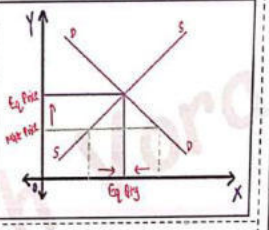
- A firm should not produce at all if its total variable costs are not met (TR≤TVC)
- When AR = AVC → Shutdown point
- Shutting down is temporary & does not mean going out of business.
- At shut down point :
  - Price is equal to AVC
  - TR = TVC
  - Total loss = TFC

Principle 2

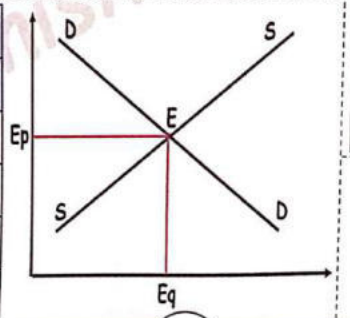
A firm will maximum profits (or minimize losses) at MR = MC



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S. No.	Situation	Effect		Diagram
1.	Mkt Price > Equi Price i.e., Qty Sup. > Qty Dem. (Surplus)	Downward Pressure on Price	Qty Supplied decreases & Qty Demanded increases Upto Equilibrium	
2.	Mkt Price < Equi Price i.e., Qty Sup < Qty Dem (Shortage)	Upward Pressure on Price	Qty Supplied increases & Qty Demanded decreases Upto Equilibrium	

S. No.	Situation	Effect	
		Equi Price	Equi Qty
3.	Increase in Demand	Increase	Increase
4.	Decrease in Demand	Decrease	Decrease
5.	Increase in Supply	Decrease	Increase
6.	Decrease in Supply	Increase	Decrease



S. No.	Situation	Effect	
		Equi Price	Equi Qty
7.	Increase in Demand is equal to Increase in Supply	Remains Same	Increase
8.	Increase in Demand is greater than Increase in Supply	Increase	Increase
9.	Increase in Demand is less than Increase in Supply	Decrease	Increase
10.	Decrease in Demand is equal to Decrease in Supply	Remains same	Decrease
11.	Decrease in Demand is greater than Decrease in Supply	Decrease	Decrease
12.	Decrease in Demand is less than Decrease in Supply	Increase	Decrease

- When **both demand & supply increase**, but no other data given→ then **EQ increases**, but effect on EP cannot be determined
- Similarly, when **both demand & supply decrease**, but no other data given→ then **EQ decrases**, but effect on EP cannot be determined

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S. No.	Situation	Effect	
		Equi Price	Equi Qty
13.	Increase in Demand is equal to Decrease in Supply	Increases	Remains Same
14,	Increase in Demand is greater than Decrease in Supply	Increases	Increases
15.	Increase in Demand is less than Decrease in Supply	Increases	Decreases
16.	Decrease in Demand is equal to Increase in Supply	Decreases	Remains Same
17.	Decrease in Demand is less than Increase in Supply	Decreases	Increases
18.	Decrease in Demand is greater than Increase in Supply	Decreases	Decreases

- When demand increases & supply decreases→ EP rises but effect on EQ cannot be determined
- When demand decreases & supply increases→ EP falls but effect on EQ cannot be determined

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Introduction

- The price of a commodity and the quantity exchanged per time period depend on
  - the market demand and supply functions and
  - the market structure.
- Market structure → the way sellers & buyers interact to determine equilibrium price and quantity. It determines a firm's power to fix the price of its product. [Bargaining Power]
- The level of profit maximising price is generally different in different kinds of markets due to differences in the nature of competition.
- In this unit we will discuss four market structure-
  1) perfect competition,
  2) monopoly,
  3) monopolistic competition &
  4) oligopoly

and how these market structures operate to determine short-run and long-run equilibrium price and quantity.

Perfect Competition

Features / Characteristics of Perfect Competition

1	Large number of buyers and sellers	➢ Share of each seller & buyer in market → is too small → unable to influence price, demand or supply
2	Homogenous or Identical Products	➢ Perfect substitutes ➢ Buyers have no preference between different sellers and different units of goods
3	Free Entry & Exit	➢ No legal or market related barriers to entry & no special costs to enter an industry.

Above 3 characteristics are conditions for pure competition

4	Perfect knowledge of market condition	➢ Both buyers and sellers have all information relevant to their decision to buy or sell
5	Very low transaction costs	➢ Buyers and sellers do not have to spend much time and money finding each other ➢ No advertisement required.
6	All firms individually are price takers	➢ Firms accept price determined by market forces ➢ Price taking applies to consumers as well ➢ There is perfect knowledge and perfect mobility, if any seller raises his price, he would lose his customers.

- Perfect comp is a myth.
- Eg- agricultural products, financial instruments (stock, bonds, foreign exchange), precious metals (gold, silver, platinum)

the above examples approach the condition of perfect competition

Notes

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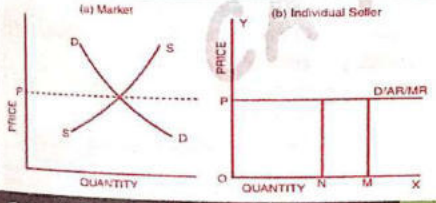
Perfect Competition

Equilibrium of PC Industry in Short Run

- **Industry** → large number of independent firms in similar business
- When **total output (Mkt supply) of industry** is **equal** to **total demand (Mkt Demand)** → industry is in **equilibrium** in short run

Equilibrium of PC Firm

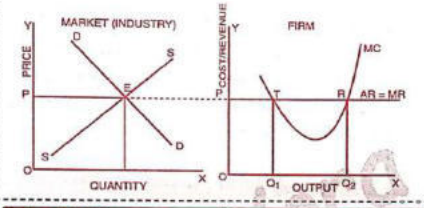
- Firm is in equilibrium → **maximizes its profit.**
- **Output which gives maximum profit** to the firm is called **equilibrium output.** In the equilibrium state, the firm has **no incentive** either to **increase or decrease its output.**
- PC Firms are **price-takers.** They **have to accept price determined by market forces.**
- Demand curve of each PC firm is **perfectly (or infinitely) elastic**
- In PC firm, **MC curve above AVC** has identical shape of firm's **supply curve.**



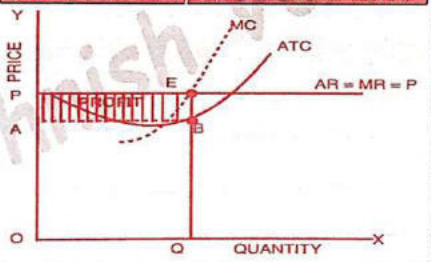
Conditions for Equilibrium of PC Firm in Short Run

1st order condition → **MR = MC**

2nd order condition → **MC curve** should **cut MR curve from below.** (**MC → positive slope**)



Can PC Firm earn profits in SHORT RUN ?

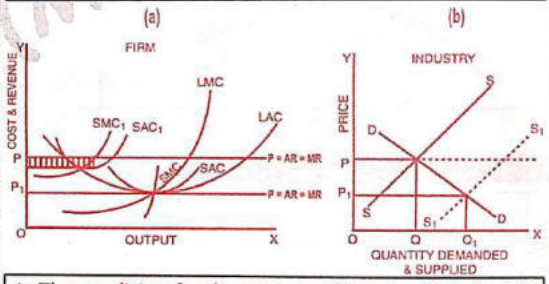


A PC firm can in short run-

- ☐ **Normal Profit** → **AR=AC** or
- ☐ **Super Normal Profit** → **AR > AC** or
- ☐ **Losses** → **AR < AC**

Equilibrium of PC Firm in Long Run

- In long run → firms can alter scale of operation & freely enter or exit PC industry.
- PC firms are in **long run equilibrium** → when they have **adjusted their plant to produce** at **minimum point of their LAC curve,** which is **tangent to the demand curve** defined by the market price.
- In **long run,** all PC firms will be **earning just normal profits,** which are included in the ATC.



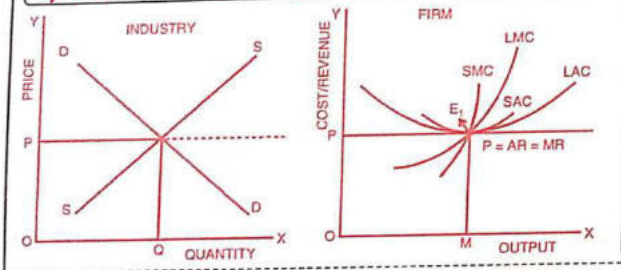
- The **condition** for **long run equilibrium of PC firm** is that **MC = Price** (AR) and **MC = LAC**
- At equilibrium, **SMC = LMC = SAC = LAC = P = MR**

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Equilibrium of PC Industry in Long Run

Three conditions:
1) All firms in industry are in equilibrium (maximizing profit)
2) No firm has an incentive either to enter or exit industry as all firms are earning normal profit.
3) Price is such that mkt supply = mkt demand



- A firm producing output at optimum cost (min pt of LAC) → optimum firm. In long run, all PC firms are optimum firms having optimum size
- Thus, under PC, in long run→ market mechanism leads to optimal allocation of resources which is shown by-

(a) Output is produced at minimum feasible cost.
(b) Consumers pay minimum possible price→ just covers MC i.e. MC = AR. (P = MC)
(c) Plants are used to full capacity → no wastage of resources i.e. MC = AC.
(d) Firms earn only normal profits i.e. AC = AR.
(e) Firms maximize profits (i.e. MC = MR), but the level of profits will be just normal.
(f) There is optimum number of firms in the industry.

In other words, in the long run,
LAR = LMR = P = LMC = LAC → optimum allocation of resources.

Monopoly

'Monopoly' = "alone to sell".
Monopoly is a situation in which there is a single seller of a product which has no close substitute.

Pure monopoly is never found in practice. However, in public utilities such as transport, water &electricity, we may find monopoly market.

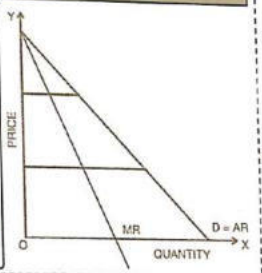
Features of Monopoly

1	Single seller of product	• Only one firm producing or supplying a product. • No distinction between firm and industry (absence of competition)
2	Barriers to Entry	• Strong barriers to entry which could be economic, institutional, legal or artificial.
3	Market power	• Monopoly firm has ability to charge a price above MC and earn a positive profit (AR > MC)
3	No close substitutes	• Monopoly firm has control over market supply (price maker) • Sells a product which has no close substitutes. • Cross elasticity of demand = zero or very small. • Price elasticity of demand is less than 1. • Steep downward sloping demand curve.

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Monopolist's Revenue Curves

- AR & MR **both** are downward sloping curves.
- **Slope of MR = 2 x Slope of AR**
  MR curve lies half-way between **AR curve & Y axis.** i.e. it **cuts** horizontal line between Y axis & AR into **two equal parts**
- **AR cannot be zero**, but **MR** can be **zero or even negative.**



Monopolies are mainly of two types

Simple monopoly

Here the monopolist charges **uniform price** from all buyers

For eg, Indian Railways charging same fare from all AC 3Tier passengers

Discriminating monopoly

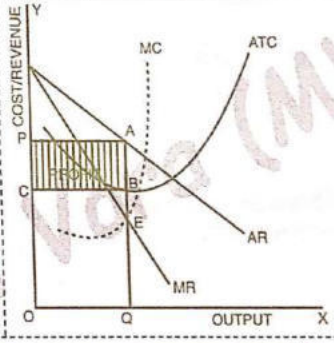
Here the monopolist **charges different prices** from **different buyers** of same good or service

For eg. Dynamic fare charged by Indian Railways in specific trains.

Conditions for Equilibrium of Monopoly in Short Run

1st order condition→ **MR = MC**

2nd order condition→ **MC curve should cut MR curve from below. (MC → positive slope)**



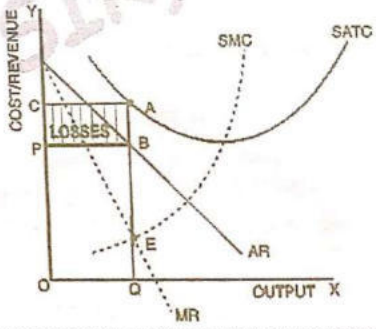
Can a monopolist incur losses in short run?

YES, if **AR < AC**

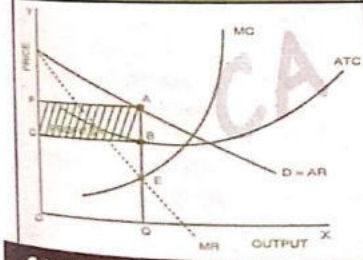
Should firm shutdown ?

It depends,

If **AR < AVC**, then shutdown or else continue



Equilibrium of Monopoly in Long Run



- In **absence of competition**, monopolist **need not produce at optimal level.** He can **produce at a sub-optimal scale also.**
- He **need not reach minimum of LAC** curve; he **can stop at any point** on the LAC **where his profits are maximum.**
- **Monopolist will not continue** if he makes **losses in long run.** He will **continue** to make **super normal profits** even in **long run** as **entry of outside firms is blocked.**

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ECONOMICS CHAPTER 4 | UNIT 3 - PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

Price Discrimination

- Price discrimination occurs when a **producer sells** a specific G/S to **different buyers** at **two or more different prices** for **reasons not associated with differences in cost**.
- Adopted by a **monopolist** → **to earn abnormal profits.**
- Price discrimination **cannot persist under perfect competition** as PC firms have no influence over price.

Conditions for Price Discrimination

1) **Seller** should have **some control over supply** of his product (**price-setting power**)
2) Seller should be **able to divide his market** into **two or more sub-markets.**
3) **Price-elasticity** of product should be **different in different sub-markets.**

Charge **high price** → for buyers having **inelastic demand**
Charges **low price** → for buyers having **elastic demand**

4) **Not be possible** for **buyers of low-priced market** to **resell** to **buyers of high-priced** market (**no market arbitrage**)

Objectives of Price Discrimination

(a) to earn **maximum profit**
(b) to **dispose off surplus stock**
(c) to enjoy **economies of scale**
(d) to **capture foreign markets** and
(e) to secure equity through **pricing.**

Degrees Price Discrimination by Prof. AC Pigou

First Degree (Customer Wise)	Separating market into each **individual consumer** & charge them different prices (extract entire consumer surplus) Eg- **Doctors, lawyers, consultants** etc., charging different fees, prices decided, auctions
Second Degree (Quantity wise)	**There are two possibilities here:** 1) Larger quantities available at lower unit price. Eg- **family pack of soaps** or biscuits tends to **cost less per kg than smaller packs.** 2) Each consumer pays **different price for consecutive purchases.** Eg- **mobile sim service→** charge higher internet prices when consumption exceeds a particular limit.
Third Degree (Attribute wise)	Price varies by attributes → **location** or **customer segment.** **Divide consumers into separate sub-markets** &charge **different prices in different sub-markets.** Eg- **Dumping**, charging **different prices for domestic and commercial uses, lower prices in railways for senior citizens**, etc.

Disadvantages of Price Disc.

- There is **loss of economic welfare** as the **price** paid is **higher than marginal cost.**
- Price disc. results in **reduced consumer surplus.**

Advantages of Price Disc.

- **Increase in revenue** due to price disc. will **enable some firms to stay in business**
- Many **essential services** (e.g. railways) cannot be **profitably run** unless price discrimination is followed.
- By **peak load pricing**, firms having **capacity constraints** → **spread its demand to off-peak times.**
- **Poor consumers**, will **benefit from lower prices** as they would not be able to purchase G/S, if uniform high prices are charged for all consumers

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How do monopolies arise?

1) Strategic control over a scarce resources, inputs or technology
2) Control over a unique product difficult to copy
3) Governments granting exclusive rights
4) Patents and copyrights given by govt to encourage innovation
5) Business combinations or cartels
6) Extremely large start-up costs even to enter market
7) Natural monopoly arises when there are very large economies of scale.
8) Enormous goodwill enjoyed by a firm for a long period
9) Stringent legal and regulatory requirements effectively discourage entry of new firms
10) Using anti-competitive practice (predatory tactic), like limit pricing or predatory pricing (selling below cost)

Economic effects of monopoly

1) Reduces aggregate economic welfare → loss of productive & allocative efficiency.
2) Monopolists charge higher prices & produce lower output
3) Monopolists earn economic profits in long run which are unjustifiable.
4) Monopoly prices exceed marginal costs → reduces consumer surplus.
5) Restricts consumer sovereignty
6) Monopolists may use unjust means for creating barriers to entry to sustain their monopoly power.
7) Have substantial financial resources → influence political process in order to obtain favourable legislation.
8) Do not have incentive to introduce efficient innovations
9) Use their monopoly power to pay lower prices to their suppliers.
10) Economy → suffer from 'X' inefficiency→ loss of management efficiency where competition is limited or absent.

Monopolistic Competition

- Large no. of sellers selling differentiated (similar but not identical) products → to attract customers on some basis other than price.
- Eg of monopolistic market- soaps, detergent, toothpaste etc
- Contains some features of both markets- monopoly & perfect comp.

Features of Monopolistic Competition

1	Large no. of sellers	Large number of sellers→ small share in mkt
2	Product differentiation	Products of different sellers are differentiated on basis of brands→ close substitutes→ demand is relatively elastic. Firms use size, design, colour, shape, performance, features, packaging & promotional techniques to make their products different. (may be true or fancied) This market → blend of monopoly & PC.
3	Freedom of entry and exit	Firms are free to enter or exit the market
4	Non-price competition	They indulge in aggressive advertising, product development, efficient after-sales service etc. Avoid price wars → throw few firms out of market or reduce profit margins.

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Price Determination under Monopolistic Competition

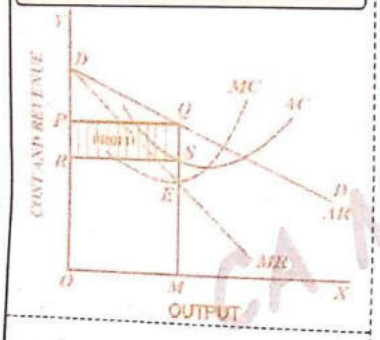
Since product is differentiated → each firm makes independent decisions about price & output.
Each firm → price maker → some control on price due to prod diff.

Less differentiation → More Similar to other products → More Substitutability → More Elastic Demand → Flatter Demand Curve

Equilibrium of Monopolistic Comp Firm in Short Run

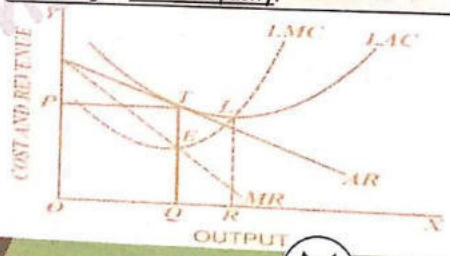
1st order condition → MR = MC

2nd order condition → MC curve should cut MR curve from below. (MC → positive slope)



Equilibrium of Monopolistic Comp Firm in Long Run

- In long run → all monopolistic comp. firms → earn only normal profits.
- At equi. → do not produce at min point of LAC → do not fully realize economies of large scale prod → not used to optimum capacity.
- Any attempt to produce more → irrational → fall in AR > fall in AC
- Long run equilibrium → produce at falling portion of LAC curve → producing lower quantity than its full capacity level → leading to excess capacity.



Important Differences

Perfect Competition	Monopolistic Competition	Monopoly
Price = MC	Price > MC	Price > MC
Price less than other markets	Price is high compared to PC	Highest equilibrium price
Demand curve is infinitely elastic (Ep = ∞)	Downward sloping and more elastic demand curve (Ep > 1)	Downward sloping and highly inelastic demand curve (Ep < 1)
TR straight line positively sloping through the origin	TR inverted U shaped	TR inverted U shaped
No price discrimination	Depends on extent of monopoly power	Can practice price discrimination
Price given, decide only about output	Decides on both price and output	Decides on both price and output
No selling costs	High selling costs	Low selling costs
LR Equi at minimum AC	LR Equi at declining portion of LAC	LR Equi generally at decline portion of LAC
Eq Qty is highest	Eq Qty less than PC	Eq Qty is lowest
No wastage of resources	Huge wastage on advertisements	Wastage of resources

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Oligopoly

- Oligopoly→ 'competition among few' (2 to 10 firms)
- Prof. Stigler defines oligopoly → "situation in which a firm bases its market policy, in part, on expected behaviour of a few close rivals".
- Eg of Oligopoly- cold drinks, automobile, Airlines, petroleum refining, power generation, mobile telephony & Internet service providers etc.

Features / Characteristics of Oligopoly

Strategic Interdependence	Each seller is big enough to influence market. A firm has to necessarily respond to its rivals' actions, and simultaneously rivals also respond to the firm's actions.
Importance of advertising and selling costs	Firms use aggressive & defensive marketing weapons to gain greater market share. Firms avoid price cutting & try to compete on non-price basis
Group Behaviour	No generally accepted theory of group behaviour. Firms may agree to pull together as a group in promotion of their common interest. May or may not have a leader.

Types of Oligopoly

1	Pure oligopoly or perfect oligopoly occurs when the product is homogeneous in nature, e.g. Aluminium industry. It tends to process raw materials (intermediate goods) that are used as inputs by other industries. Eg- are petroleum, steel, and aluminium
	Differentiated or imperfect oligopoly occurs when goods sold is based on product differentiation, e.g. Talcum powder.
2	Open oligopoly → new firms can enter market & compete with existing firms.
	In closed oligopoly entry is restricted.
3	When few firms of oligopoly market come to common understanding or act in collusion → fixing price or output or both, it is collusive oligopoly.
	When there is absence of such an understanding among the firms and they compete with each other, it is called competitive oligopoly.
4	Oligopoly is partial when industry is dominated by one large firm → looked upon as leader of group. Dominating firm will be price leader
	Full oligopoly→ Absence of price leadership.
5	Syndicated oligopoly→ Firms sell their products through a centralized syndicate.
	Organized oligopoly → Firms organize themselves into a central association for fixing prices, output, quotas, etc.

Price & output Decision

An oligopoly firm cannot have sure & determinate demand curve, since demand curve keeps shifting as rivals change their price in reaction to price change made by a firm.

Now, what price & output to be fixed cannot be ascertained.

However, economist have given some price-output models

Oligopoly Models

1) Ignore firm's inter dependence

2)a) Cournot model → firms' control variable is output. They do not collude.
2)b) Stackelberg's model leader commits to an output → rest of firms are followers
2)c) Bertrand model, price is control variable

3) Enter into agreement and try to pursue their common interests. Eg- OPEC

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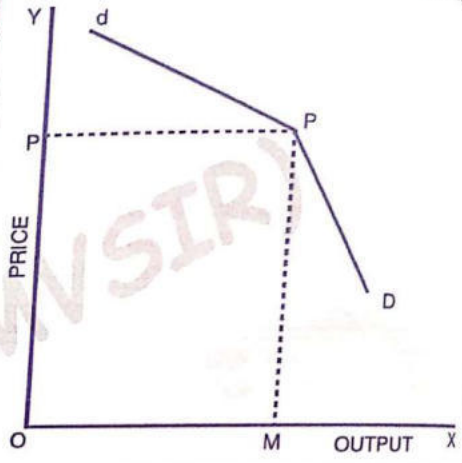
Price Leadership

- Cartels → A group of firms that explicitly agree (collude) to coordinate their activities→ leads to high market power & earn monopoly profits
- But it is possible that there is a dominant firm surrounded by many small firms (fringe firms). These firms are too unreliable→ large firm then decides how to set its price

1) Live and let live philosophy→ Dominant firm accepts presence of fringe firms and sets price to maximize its profit (price-leadership by dominant firm)
2) Price leadership by low cost firm→ Price leader sets price in a manner that it allows some profits to followers also.
3) Barometric price leadership→ An old or most respected firm acts as a leader and assesses market conditions about demand, cost, competition etc. and makes changes in price which are best from view point of all firms.

Kinked Demand Curve

- As per Paul A. Sweezy, prices in oligopolistic industries remain sticky or inflexible.
- Price rigidity under oligopoly is explained by kinked demand curve hypothesis (Sweezy's Model)
- Kinked demand curve faced by an oligopolist has a 'kink' at the level of the prevailing price.
  - segment of demand curve above prevailing price level is highly elastic (when a firm raises price, competitors do not follow)
  - segment of demand curve below prevailing price level is inelastic. (when a firm decreases price, competitors will follow)



Kinked Demand Curve

Duopoly	A subset of oligopoly where there are only two firms in market.
Monopsony	Market where there is single buyer of G/S & is applicable to factor markets in which a single firm is the only buyer of a factor.
Oligopsony	Market where there is a small number of large buyers & is relevant to factor markets.
Bilateral monopoly	Market structure where there is only a single buyer and a single seller i.e. it is combination of monopoly market & a monopsony market

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Business Economics - Paper 4

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Chapter 5

Business Cycles

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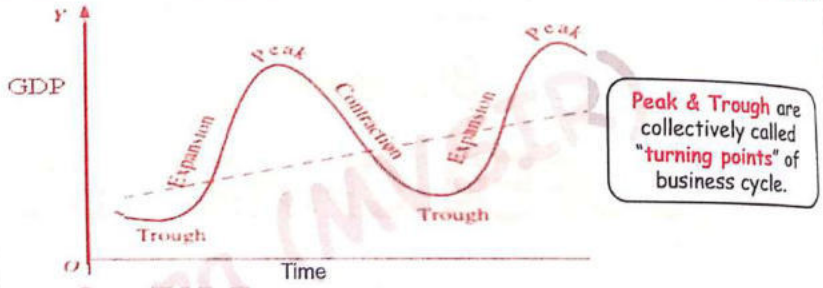
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ECONOMICS CHAPTER 5 - BUSINESS CYCLES

Business Cycles- Introduction

- The rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles.
- A trade cycle is composed of-
  - Periods of Good trade characterised by rising prices and low unemployment percentage, (Expansion)
  - Periods of bad trade characterised by falling prices and high unemployment percentages. (Contraction)
- Business cycles is that they occur again & again but not always at regular intervals, nor are they of same length.

Phases of Business Cycles → **Expansion (aka Boom or Upswing)** → **Peak (aka Prosperity)** → **Contraction (aka Downswing or Recession)** → **Trough (aka Depression)**



Peak & Trough are collectively called "turning points" of business cycle.

Expansion (aka Boom or Upswing)

Increase in national output (production of G/S)

- Increase in employment;
- Involuntary unemployment is almost zero
- Frictional unemp. (change of jobs, strikes) or
- Structural unemp. (skills mismatch) may exist.

→ Increase in income → Increase in agg. Demand (demand for all types of goods and services rises) → Increase in capital & consumer exp. → Increase in sales, profits, rising stock prices and bank credit → Increase in national output (production of G/S)

Expansion stage continues till there is full employment of resources & production is maximum possible

Peak (aka Prosperity)

Growth rate in expansion stage eventually slows down and reaches its peak.

Peak = top or highest point of business cycle.

In later stages of expansion,

- inputs are difficult to find as they are short of their demand and therefore input prices increase.
- Output prices also rise rapidly leading to increased cost of living and greater strain on fixed income earners.
- Consumers begin to review their consumption expenditure on housing, durable goods etc.

Actual demand stagnates.

It is end of expansion & it occurs when economic growth has reached point where it will stabilize & then move in reverse direction, starting contraction stage

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ECONOMICS CHAPTER 5 - BUSINESS CYCLES

Contraction (aka Downswing or Recession)

- Producers do not instantaneously recognize pulse of economy (that contraction is coming) & keep anticipating high level of demand (because earlier expansion was going on), and maintain their investments.
- Consequence is mismatch between demand & supply. Supply far exceeds demand. Gradually it spreads to all sectors.
- Producers, now being aware of above, respond by
  - ☐ holding back future investment plans,
  - ☐ cancellation of orders for equipments & inputs incl. labour.
- This in turn generates a chain of reactions in input markets and producers of capital goods and raw materials in turn respond by cancelling and curtailing their orders. This is beginning of recession.
- Decline of aggregate economic activity over a period of time is RECESSION (when contraction stage lasts for 2 or more quarters continuously, then it is called recession)

Decrease in input demand pulls input prices down

↓

Decrease in employment; Leads to decrease in income

↓

Producers lower their prices to dispose off inventories

↓

Consumers, expect further decreases in prices and postpone their purchases

→

Aggregate demand further falls, & gap between demand & supply gets further widened and recession becomes severe

↓

Business firms become pessimistic about future and Investments, prodn and emp. further decline

↓

Bank credit decreases

↓

Investor confidence is at its lowest & stock prices fall

Trough (aka Depression)

- Severe contraction in economic activities pushes economy into phase of depression.
- Growth rate becomes negative→ national income & exp. declines rapidly.
- Agg. demand decreases, prices are lowest - forcing some firms to shutdown. It leads to mounting unemployment which leaves consumers with very little income.
- A typical feature of depression is the fall in the interest rate. With low interest, people's demand for holding liquid money (i.e. in cash) increases.
- Despite lower interest rates, demand for credit declines because investors' confidence has fallen. It may lead to possible banking or financial crisis.
- Industries, especially capital and consumer durable goods industry, suffer from excess capacity. Large number of bankruptcies and liquidation.

Recovery

- The economy cannot continue to contract endlessly. Trough lasts for some time & marks end of pessimism and beginning of optimism. This reverses process.
- Process of reversal is initially felt in labour market. Pervasive unemployment forces workers to accept lower wages.
- The producers anticipate lower costs and better business environment. Slowly business confidence takes off, & firms start to invest again and to build stocks
- Technological advancements require fresh investments; thus bank credit increases. employment incr, agg. demand picks up and prices gradually rise.
- Price mechanism acts as a self-correcting process in free market economy.
- Spurring of investment causes recovery of economy. This acts as a turning point from depression to expansion.

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ECONOMICS CHAPTER 5 - BUSINESS CYCLES

Indicators

It is very difficult to predict the turning points of business cycles. Economists use changes in a variety of activities to measure the business cycle and to predict where the economy is headed towards. These are called indicators

Leading Indicators

Indicator that changes before (prior to) economy starts to follow a particular pattern.

Eg- Changes in Stock Price, value of new orders for consumer goods & capital goods, building permits for private houses, delayed deliveries

Lagging Indicators

Lagging indicators reflect economy's historical performance and changes in these indicators are observable only after an economic trend has already occurred.

If leading indicators signal the onset of business cycles, lagging indicators confirm these trends.

Eg- unemployment, corporate profits, labour cost per unit, interest rates, consumer price index, commercial lending activity

Coincidental / Concurrent Indicators

They coincide or occur simultaneously with business-cycle movements. They describe current state of business cycle.

Eg- GDP, industrial production, inflation, personal income, retail sales

Features Of Business Cycles

a) Business cycles occur periodically, but do not exhibit the same regularity. The duration & intensity of fluctuations varies.

b) The phases seldom (only sometimes) display smoothness and regularity.

c) Generally originate in free market economies. Get transmitted to all sectors.

d) Capital goods & durable consumer goods industries are disproportionately (more) affected. Industrial sector is more prone compared to agri. sector

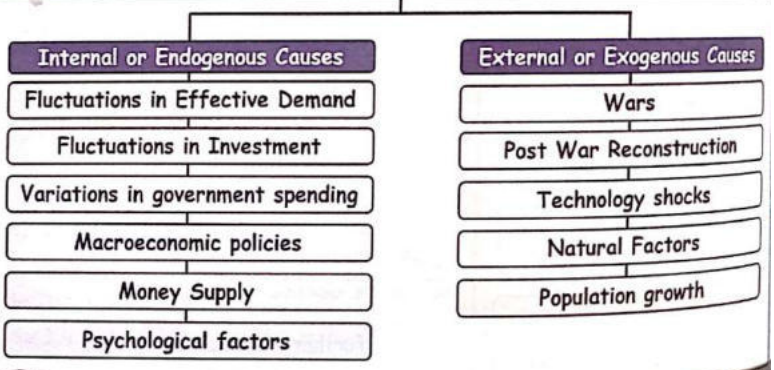
e) Complex phenomena; they do not have uniform characteristics and causes.

f) Repercussions of get simultaneously felt on nearly all economic variables

g) Contagious and are international in character.

h) Have serious consequences on well-being of society.

Causes Of Business Cycles



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ECONOMICS CHAPTER 5 - BUSINESS CYCLES

Causes Of Business Cycles

Macroeconomic policies (monetary & fiscal policies) also cause business cycle

- **Expansionary policies** – Policies resulting in increasing agg. demand (Results in booms)
  - Fiscal Policy- Increase government spending and tax cuts,
  - Monetary Policy- Softening (decr) interest rates.
- **Anti-inflationary measures** – Policies resulting in decreasing agg. demand (Controlling inflation)
  - Fiscal Policy- Decrease government spending and increasing tax,
  - Monetary Policy- Increasing interest rates.

Keynes	Business Cycles are caused due to fluctuations in aggregate effective demand
Pigou	Business Cycles are caused due to anticipations of business firms & are affected by waves of optimism or pessimism
Schumpeter	Business Cycles are caused due to innovation theory.
Nicholas Kaldor	Business Cycles are caused due to cobweb theory - present prices substantially influence production at some future date.
Hawtrey	Business cycle is purely monetary phenomenon. Unplanned changes in supply of money may cause business fluctuation.

Other Important Points

Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "cyclical" businesses.

These include fashion retailers, electrical goods, house-builders, restaurants, advertising, overseas tour operators, construction and other infrastructure firms.

During a boom, such businesses see a strong demand for their products but during a slump, they usually suffer a sharp drop in demand.

Demand-Pull Inflation

If demand for goods and services is more than their supply, the resultant increase in price is called Demand-Pull Inflation

Examples of Business Cycles

1) Great Depression of 1930

Longest & deepest depression of 20th century → during 1930s in USA. Global GDP fell by 15%. Keynes regarded lower aggregate exp as the cause while as per monetarists banking crisis and low money supply were the causes

2) Information Technology bubble burst of 2000

Aka. Dot.Com bubble (1997-2000). Many new Internet-based cos. (dot-com cos.) were started. Due to over-optimism, investors were less cautious & stock prices of these cos. increased, but could not sustain & stock market crashed.

3) Global Economic Crisis (2008-09)

After IT Bubble burst, With lower interest rates → households, even with low creditworthiness, began to buy houses using loans. Increased demand for houses led to increased prices.

Loans were given even to sub-prime households. Houses were built in excess during boom & due to oversupply, house prices began to decline in 2006.

Housing bubble got burst in the second half of 2007. Sub-prime households started defaulting on large scale & caused huge losses to the banks.

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Chapter 6

Determination of National Income

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National Income - Basics

- The performance of an economy depends on the output of goods and services produced by it, which is measured by National Income.
- National Income is defined as the -
  - net value of
  - all economic goods and services
  - produced
  - within the domestic territory of a country
  - in an accounting year
  - plus the net factor income from abroad.
- According to the Central Statistical Organisation (CSO) 'National income is the sum total of factor incomes generated by the normal residents of a country in the form of wages, rent, interest and profit in an accounting year'.

Usefulness And Significance Of National Income Estimates

1) It provides a framework for analyzing the short-run performance.
2) The distribution pattern of national income helps businesses to forecast future demand.
3) Economic welfare depends on magnitude and distribution of national income
4) NI shows composition and structure of NI of different sectors & variations in them. Helps to make comparisons of trend and speed of development
5) Provides quantitative basis for assessing, choosing & evaluating economic policies
6) Shows income distribution and possible inequality in its distribution. Make comparisons of statistics, such as ratios of investment, taxes, to GDP
7) Provides guide to make policies for growth and inflation

In order to calculate National Income, first we need to understand the concept of GDP.

Gross domestic product (GDP) is a measure of-

- monetary value of
- all final
- economic goods and services,
- gross of depreciation,
- produced within the domestic territory of a country
- during a given time period.

Monetary Value

Money enables us to measure and find aggregate of different types of products expressed in different units of measurement by converting them in terms of Rupees

Final Goods

Final goods are used either-

- for consumption [Household sector]; or
- for investment. [Business Sector]

They are neither resold nor undergo further transformation in process of production.

Intermediate goods

- Intermediate goods refer to those goods which are used either for
  - resale or
  - for further production in the same year.

They do not end up in final consumption, and are not capital goods either.

- They have derived demand. Intermediate goods are used up in the same year; if they remain for more than one year, then they are treated as final goods.

Flow Measure

NI & GDP is a 'flow' measure of output per time period and includes only those G/S produced in current period

Economic Activities

NI & GDP includes those G/S, which are produced through economic activity, which are exchanged in market & valued at market price

2 types of goods used in production process which are counted in GDP

1) Capital goods and
2) Inventory investment = Closing Stock - Opening Stock

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Exclusions from GDP

- **Transfer Payments** - Government making a payment, without goods or services being received in return. Eg- social security benefits, unemployment compensation etc.
- **Financial transactions** - Stocks & bonds which are exchanged during the period are **not included** - do not directly involve current production. However, value of services that accompany sale and purchase (e.g. fees paid to real estate agents and lawyers) is included.
- **Sale of 2nd Hand goods**
- **Non-reported output** - illegal transactions. Eg - narcotics and gambling

Real GDP

- Real GDP or GDP at constant prices refers to the total money value of the final goods and services produced within the domestic territory of a country during an accounting year, estimated using base year prices.
- It is an inflation adjusted measure
- It is not affected by changes in prices;
- It changes only when there is change in the amount of output produced in the economy.
- Real GDP is a better measure of economic well being as it shows the true picture of the change in production of an economy.

Nominal GDP

- 'Nominal GDP' or 'GDP at current prices' - GDP estimated on basis of current year's market prices, it is called.
- Nominal GDP changes from year to year for **two reasons.**
  1) The amount of goods and services produced changes, and
  2) When market prices change. Changes in GDP due to changes in prices fail to correctly explain performance of economy.

GDP Deflator

$$\text{GDP Deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

$$\text{Inflation rate in Yr 2} = \frac{\text{GDP deflator in Yr 2} - \text{GDP deflator in Yr 1}}{\text{GDP Deflator in Yr 1}} \times 100$$

Domestic Vs National

- The term 'national' refers to normal residents of a country who may be within or outside the domestic territory of a country and is a broader concept compared to the term 'domestic'.
- The term 'domestic' refers to production done by people WITHIN the domestic territory

		GDP	GNP
1.	Earnings from production in India that accrue to foreign residents or foreign-owned firms	Included	Excluded
2.	Profits earned in India by X Company, foreign-owned firm	Included	Excluded
3.	Earnings of Indian corporations overseas	Excluded	Included
4.	Earnings of Indian residents working overseas	Excluded	Included
5.	Profits earned by Company Y, an Indian company in UK	Excluded	Included

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Net Factor income from abroad (NFIA)

Factor income earned by domestic factors of production employed in rest of world **–** Factor income earned by factors of production of rest of world employed in domestic territory

Operating Surplus

Income from Property + Income from Entrepreneurship
OR
Rent + Interest + Profit

Market Value Vs Factor Cost

MP = FC + Indirect Tax – Subsidy
OR
MP = FC + Net Indirect Tax

Mixed Income of Self Employed

Difficult to separate labour income from capital income when people provide both labour and capital services. Eg- self-employed like lawyers, engineers, proprietors etc.

	Gross Domestic Product at Factor Cost (GDP FC)
=	GDP MP - Indirect Taxes + Subsidies
	OR
	Compensation of employees
+	Operating Surplus (rent + interest+ profit)
+	Mixed Income of Self- employed
+	Depreciation

GDP Per Capita

- Measure of country's economic output per person.
- Indicator of the standard of living of a country.
- GDP Per Capita = Real GDP / Total Population

	Net Domestic Product at Factor Cost (NDP FC) (AKA - Domestic Income or Factor Income earned in Domestic Territory)
=	NDP MP - Indirect Taxes + Subsidies
	OR
=	NDP MP - Net Indirect Taxes
	OR
=	Compensation of employees
+	Operating Surplus (rent + interest+ profit)
+	Mixed Income of Self- employed

National Income (NNPFC)

FI earned in Domestic Territory (FID) + NFIA
OR
NDPFC + NFIA

Total 8 Aggregates

1) GDP at MP
2) GDP at FC
3) NDP at MP
4) NDP at FC
5) GNP at MP
6) GNP at FC
7) NNP at MP
8) NNP at FC

Example

	Gross Domestic Product at Market Price (GDP MP)
-	Depreciated
	Net Domestic Product at Market Price (NDP MP)
+	Net Factor Income from Abroad (NFIA)
	Net National Product at Market Price (NNP MP)
-	Indirect Taxes
+	Subsidy
	Net National Product at Factor Cost (NNP FC)

3 Golden Rules of NI

1) Gross – Depreciation = Net
2) MP = FC + IDT - Subsidy
   or
   MP = FC + NIT
3) Domestic + NFIA = National

Indirect Taxes and Subsidies

1) Production Taxes & Production Subsidies
These are independent of the volume of actual production
2) Product Taxes & Product Subsidies
Paid or received on per unit of product

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Basic Price	
=	Factor Price
+	Production Taxes
-	Production Subsidy

Market Price	
=	Basic Price
+	Product Taxes
-	Product Subsidy

Thus, market price-
- includes both product tax as well as production tax & subsidies.
- excludes both product and production subsidies.

Domestic Income (NDPfc) has 2 parts

Part 1: Income from domestic product accruing to the public sector-
= Income from P/E accruing to govt admin dep - Savings of Non dep enterprises
Where, Departmental Enterprise include- Railways, Post & telegraph etc
Non-Departmental Enterprise include- IOCL, GAIL, LIC etc

Part 2: Income from domestic product accruing to private sector
= NDPfc - Inc. from P/E accruing to govt admin dep - Savings of Non dep ent.

Personal Income
Income received by household sector including Non-Profit Institutions Serving Households from all sources

PI (Basic Formula)	
=	National Income
+	income recd but not earned
-	income earned but not recd

PI (3rd Formula)	
=	National Income
-	Income from prop & ent. accruing to govt admin dep.
-	Saving of non-dept ent.
-	Saving of private corporates
-	Corporate profit tax
+	National debt interest
+	Current transfers from government and ROW

PI (2nd Formula)	
=	National Income
-	Undistributed profits
-	Net interest payments made by households
-	Corporate Tax
+	Trf Pay to households

Disposable Personal Income (DI)
It is a measure of amount of money in the hands of the individuals that is available for their consumption or savings.
DI = Personal Income - Personal Income Tax - Non Tax Payment

Private Income
It is a measure of the income (both factor income and transfer income) which accrues to private sector from all sources within and outside the country.

	Private Income
=	Income from domestic product accruing to private sector
+	Net factor income from abroad
+	National debt interest
+	Current transfers from government & rest of world

Personal Inocme (4th Formula)	
=	Private Income
+	Undistributed Profits
-	Corporate Tax

Net National Disposable Income (NNDI)- The amount of G/S domestic economy has at its disposal.
- NNDI = NNPfc + Net IDT + Net Current Trf. from rest of world
- GNDI = NNDI + Depreciation

Ignore "Govt transfer pay" in GNDI/NNDI

Particulars	Includes	Remarks
National Income	Earned Income recd. or not recd.	All sectors
Personal Income	Earned Income recd. & Transfer Income recd.	Household sector including NPISH
Private Income	Earned Income recd. or not recd. & Transfer Income recd. or not recd.	Private Sector
Income from Domestic Product accruing to Private Sector	NDP fc - Public Sector Income	Private Sector

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Circular flow of income

Circular flow of income refers to the continuous circulation of- production, income generation & expenditure involving different sectors of the economy. There are 3 phases-

Production phase	Firms produce G/S with help of factor services.
Income or Distribution phase	The flow of factor incomes in the form of rent, wages, interest and profits from firms to the households occurs
Exp. or Disposition phase	Income received by factors is spent on consumption of G/S and investment goods. This exp. leads to further production of G/S & sustains circular flow.

Methods of National Income Calculation & Data required

Method	Data Required	What is measured?
Value Added Method or Product Method or Industrial Origin or Net Output Method	The sum of net values added by all the producing enterprises of the country	Contribution production units
Factor Income Method or Factor Payment or Distributed Share	Total factor incomes generated in the production of goods and services	Relative contribution of factor owners
Expenditure method or Income Disposal	Sum of exp. of 3 spending units- 1. government, 2. consumer households, and 3. producing enterprises (firms)	Flow of consumption and investment expenditures

Notes

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Important Points of Value Added Method

	Value of Output in PS
-	Intermediate Cons. in PS
=	GVA by PS

+

	Value of Output in SS
-	Intermediate Cons. in SS
=	GVA by SS

+

	Value of Output in TS
-	Intermediate Cons. in TS
=	GVA by TS

Gross Value Added at Market Price (GVA mp) or GDP mp

The values of the following items are **also included** as per Product Method

a) own account production of fixed assets
b) Imputed value of production of goods for self consumption (eg- agriculture)
c) imputed rent of owner occupied houses
d) Change in Stock

If Value of Output is not given separately

	Value of Output
=	Sales + Change in Stock

Where,
Change in Stock = Cl. Stock – Op. Stock

Important Points of Income Method

	Compensation of Employees
+	Operating Surplus (R, I, P)
+	Mixed Income of Self-Emp
=	NDP fc
+	NFIA
=	NNP fc (National Income)

Income earned by owners of primary factors of prod. are included. Thus, while wages of labourers will be included, Pensions of retired workers will be excluded.

C.O.E. **includes** - wages and sal., bonus, D.A., commission, employers' contri. to PF and imputed value of pay in kind.

Important Points of Expenditure Method

GDP mp = $\sum$ Final Expenditure = $C + I + G + (X-M)$

Private Final Consumption Expenditure (PFCE)

Exp. on Final Goods by Households & NPISH

+ Value of primary products which produced for own cons.,

+ Payments for domestic services which one household renders to another,

+ Net exp. on foreign financial assets or net foreign invt.

Government / Public Final Consumption Exp. (GFCE)

The money spent by government in production of services such as defence, education, healthcare etc.

Government expenditure on pensions, scholarships, unemployment allowance etc. should be excluded because these are transfer payments.

Gross Domestic Capital Formation (GDCF)

- It includes-
  - Gross Domestic Fixed Capital Formation, i.e Invt in Fixed Assets by household, Pvt Business, Govt
  - Changes in Inventory OR Inventory Investment
  - Net Acquisition of Valuables
- GDCF – Dep = NDCF

Net Exports

Exports – Imports

Exports depict the expenditure made by foreigners on goods produced in Domestic country

Non-labour income - rent (actual & imputed), royalty, interest on loans for productive services

Profit = Corp. taxes + Div + R.E.

Int. paid by govt. on public debt, int. on consumption loans and interest paid by one firm to another are **excluded**.

Capital gains, windfall profits, transfer incomes, income from sale of 2nd hand goods & financial assets & payments out of past savings are **not included**.

However, commissions, brokerages and imputed value of services provided by owners of production units will be **included**.

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Who is responsible for calculating National Income in India ?

National Accounts Statistics (NAS) are compiled by National Accounts Division of Central Statistical Organization (CSO) in the Ministry of Statistics and Programmed Implementation (MoSP&I) is responsible for the compilation of National accounts statistics.

Measurement Of National Income In India

Reliable statistical data is not available, thus it is not possible to estimate India's NI wholly by one method.

Therefore, a combination of output method and income method is used.

- Value-added method is used in - commodity producing sectors like agriculture and manufacturing.
- In small scale sector net value added is estimated by the income method and
- In construction sector net value added is estimated by the expenditure method also.

Method considered suitable for measurement of National Income of developed economies:
Income method may be most suitable for developed economies where data in respect of factor income is rea available. With the growing facility in the use of the commodity flow method of estimating expenditures, an increas proportion of the national income is being estimated by expenditure method

System Of Regional Accounts In India

State Income or **Net State Domestic Product (NSDP)** is a measure in monetary terms of volume of all G/S produced in state within a given period of time (generally a year) accounted without duplication.

Per Capita State Income is obtained by dividing the NSDP (State Income) by the midyear projected population of the state.

State level estimates are prepared by the State Income Units of respective State Directorates of Economics and Statistics (DESs). CSO assists & advices in preparation

Certain activities such as railways, communications, banking and insurance and central government administration, that **cut across state boundaries**, and thus their economic contribution cannot be assigned to any one state directly are known as the '**Supra-regional sectors**' of the economy. The estimates for these activities are compiled for economy as a whole and allocated to states on basis of relevant indicators.

Can GDP a country be taken as an index of welfare?

No, since GDP measures **exclude** the following which are **critical for the overall wellbeing** of citizens.

a) Income distributions

b) Quality improvements in systems and processes due to technological as well as managerial innovations.

c) Productions hidden from govt., either they are evading taxes or because it is illegal (drugs, gambling etc.).

d) Non-market production and Non-economic contributors to well-being for example: health of a country's citizens, education levels etc.

e) Economic 'bads' for example: crime, pollution, traffic congestion etc which make us worse off.

f) Volunteer work rendered without remuneration

g) Many things that contribute to our economic welfare such as, leisure time, fairness, gender equality, security of community feeling etc.,

Limitations And Challenges of N

Conceptual difficulties

1) lack of an agreed definition c national income,
2) accurate distinction betwee final & intermediate goods,
3) issue of transfer payments,
4) difficulty of incorporatin distribution of income,
5) valuation of a new good at constant prices, and

Challenges

1) Inadequacy of data and lack of reliability of available data,
2) absence of recording of incomes due to illiteracy and ignorance,
3) lack of proper occupational classification, and
4) accurate estimation of consumption of fixed capital
5) production for self-consumption

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Introduction

- In previous unit, 'ex post' (realized) values were used Eg- aggregate consumption (C) denotes what people have actually consumed
- In this unit variables are defined in 'ex-ante' (anticipated) terms or in terms of what is intended or planned. In theoretical model of economy which (discussed in this unit), 'ex ante' values of these variables are our primary concern.

Eg- here 'consumption' - what people in an economy plan to consume

- Ex-ante values are used, if we want to predict what equilibrium value of output or GDP is.

- Before Keynes, classical economists said that economy is self-regulating and is always capable of automatically achieving equilibrium at 'natural level' of real GDP
- However, Keynes in his "General Theory of Employment Interest and Money (1936)" argued that markets would not automatically lead to full-employment equilibrium.
- Keynesians believe that prices and wages are not so flexible; they are sticky (rigid), especially downward. This prevents economy from returning to natural level of real GDP.
- So, output will remain at less than full employment level unless there is insufficient spending.
- Keynesian theory of income determination is presented in 3 models:

1) Two-sector = household + business,
2) Three-sector = household + business + government,
3) Four-sector = household + business + govt. + foreign

Circular Flow in a Simple Two-sector Model

- The circular flow of income is a process where the national income and expenditure of an economy flow in a circular manner continuously through time.
- Two sector economy model assumes only two sectors in economy viz., households and firms, with only consumption and investment outlays.
- Households are assumed to-
  - own all factors of production and
  - they sell their factor services to earn factor incomes
  - Income is entirely spent to consume all final G/S produced by business firms.
- Business firms are assumed to-
  - hire factors of production from the households;
  - they produce and sell goods and services to the households and
  - They do not save. There are no corporations, corporate savings or retained earnings.
- Since there is no govt, Y = Yd.

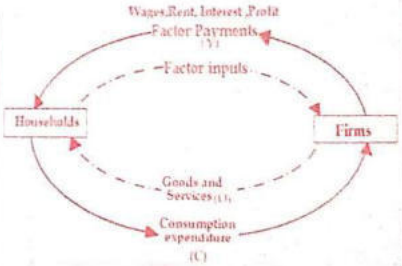
- **Assumptions**
  - All prices (including factor prices), supply of capital and technology remain constant.
  - The government sector does not exist.
  - It is closed economy, no exports and imports.
  - All investment outlay is autonomous & net

- In the figure-
  - Circular broken lines - factor and product flows- 'real flows'
  - Continuous line with arrows show money flows

These flows are in opposite directions and the value of real flows equal the money flows because the factor payments are equal to household incomes.

- No injections into or leakages from system. Since whole of household income is spent on G/S produced by firms,

household exp. = receipts of firms = value of output



Factor Payments
= Household Income
= Household Expenditure
= Value of Output
= Total Receipts of Firms

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Consumption function

The consumption function describes the functional relationship between consumption spending and disposable income

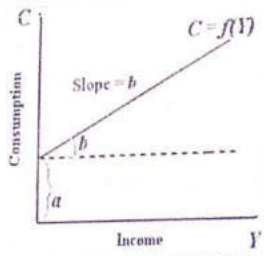
$C = a + b.Yd$

Average Propensity to Consume

The ratio of **total consumption** to **total income** is known as APC

$APC = C / Y$

Consumption is **decreasing function of level of income.**



Marginal Propensity to Consume (MPC = "b")

Increment to consumer expenditure per unit of increment to income

$MPC = \Delta C / \Delta Y = b$

Keynes assumes that **consumption increases with an increase in Yd**, but that increase in cons. < increase in Yd (b <1). i.e. $0 < b < 1$

MPC is slope of consumption line

Y	C	S	MPC	MPS	APC	APS
0	50	-50	-	-	∞	-∞
100	125	-25	0.75	0.25	1.25	-0.25
200	200	0	0.75	0.25	1.00	0
300	275	25	0.75	0.25	0.92	0.08
400	350	50	0.75	0.25	0.88	0.12

Saving function

Income not spent on consumption is saved. Savings function shows **functional relationship between national income and saving.**

$S = f(Y)$

Marginal Propensity to Save

Increment in saving per unit increase in disposable income.

$MPS = \Delta S / \Delta Y = 1 - b$

$MPC + MPS = 1$; $MPS\ 0 < b < 1$

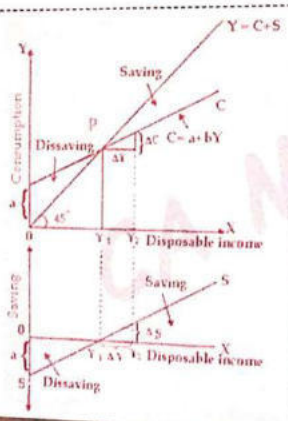
Also, **MPS is slope of savings line**

Average Propensity to Save

The ratio of **total saving** to **total income** is called APS.

$APS = S / Y$

Saving is **increasing function of level of income.**



- In the figure, the consumption and saving functions are graphed.
- **Saving function** shows level of saving (S) at each level of disposable income (Y). Saving curve has **negative intercept (-a)** on Y axis and its **magnitude** is the **same as the positive intercept** of the **consumption** curve.
- **Consumption at zero level** of income is positive (equal to **a**), and as such there should be **dissaving** also of the same magnitude.
- By definition, national income Y = C + S, which shows that disposable income is, by definition, consumption plus saving.
- Therefore, **S = Y - C**. When national income is equal to Y1, C=Y and saving curve crosses X axis.
- Thus, when we represent the theory of the consumption-income relationship, it also implicitly establishes the saving-income relationship.

Aggregate Supply (AS)

Ex ante or planned aggregate supply is the **total supply of goods and services** which firms in a national economy plan on selling during a specific time period.

AS = Agg. Production = Factor Payments = Factor Incomes [National Income→ Y]

Aggregate Demand (AD)

Aggregate demand (AD) is total planned expenditure in the economy.

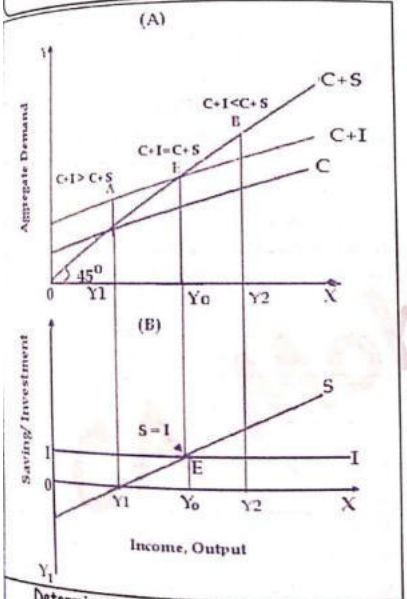
Equilibrium output

Equilibrium output occurs when **desired amount of output demanded** in economy **exactly equals amount produced** in given time period.

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Two Sector Model

- Household Sector & Business Sector only
- AD = C + I (I is assumed to be constant)
- AS = C + S
- Equilibrium is achieved when -
  AD = AS or C + I = C + S or I = S



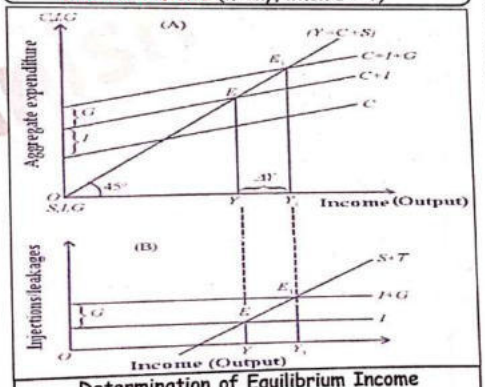
Determination of Equilibrium Income in Two Sector Model

Three Sector Model

- Household + Business + Government Sector
- AD = C + I + G
  (I & G are assumed to be constant)
- AS = C + S + T
- Equilibrium is achieved when -
  AD = AS or C + I + G = C + S + T or I + G = S + T0

Government sector adds following flows to circular flow of 2 sector model:

1) **Taxes** on households and business sector
2) **Transfer payments** to household sector and **subsidy payments** to business sector
3) **Govt purchases** G/S from business sector and **factors of prod from household**, and
4) **Govt borrowing in financial markets** to **finance deficits** (if any, when G > T)



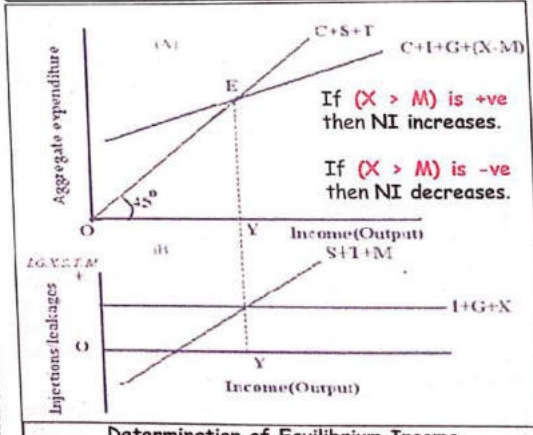
Determination of Equilibrium Income in Three Sector Model

Four Sector Model

- Household + Business + Govt. + Foreign Sector
- AD = C + I + G + (X - M)
  (I, G & X are assumed to be constant)
- AS = C + S + T
- Equilibrium is achieved when -
  AD = AS or C + I + G + (X - M) = C + S + T or I + G + X = S + T + M

Foreign sector adds following flows to circular flow of 3 sector model:

1) **exports**,
2) **imports** and
3) **net capital inflow** which is the difference between capital outflow and capital inflow



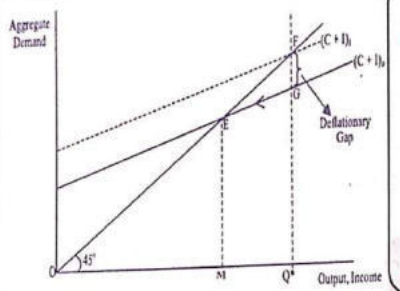
Determination of Equilibrium Income in Four Sector Model

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Leakage & Injection

- **Leakage-** It is referred to as an **outflow of income from the circular flow model**. Leakages are that part of the income which is **not used to purchase goods** or what households withdraws.
  - In 2 sector Model : Leakages = Savings
  - In 3 sector Model : Leakages = Savings + Taxes
  - In 4 sector Model : Leakages = Savings + Taxes + Imports
- **Injection-** It is an **inflow of income to the circular flow.** Due to injection, the **volume of income increases.**
  - In 2 sector Model : Injection = Investment
  - In 3 sector Model : Injection = Investment + Govt Exp
  - In 4 sector Model : Injection = Investment + Govt Exp + Exports
- When **AS = AD → Leakages = Injections**
  Then **national income** will be in **equilibrium.**
- When **AS > AD → Leakages > Injections**
  Stock Surplus or Deficient Demand - it means that **people are spending lesser volume of money** on consumption. Thus **inventories** of goods will **pile up**. Consequently, **firms would decrease their production in future** which would **lead to a fall in output** and **income in future. (NI will fall)**
- When **AS < AD → Leakages < Injections**
  Stock Shortage or Excess Demand -
  Excess demand makes businesses to **sell more than** what they **currently produce.** The **unexpected sales** would **draw down inventories** and result in less inventory investment than business firms planned. They will react by **hiring more workers** and **expanding production.** This will **increase the nation's aggregate** income. **(NI will rise)**

If there is any deviation from equilibrium, the **process of readjustment** will **bring the economy back to equilibrium.**

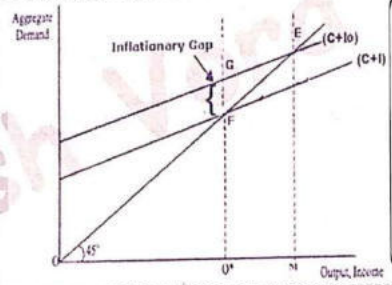


Deflationary Gap

If AD is for an **amount of output less than full employment level of output**, then we say there is **deficient demand.**

Deficient demand gives rise to a '**deflationary gap**' or '**recessionary gap**' or '**contractionary gap**'. It occurs when economy is in contraction.

Firms will **experience unplanned build-up of inventories of unsold goods** and they will **respond by cutting production** and **employment** leading to **decrease in output and income** until the **under-employment equilibrium is reached at E.**



Inflationary Gap

If AD is for an amount of output **greater than full employment level of output**, then we say there is **excess demand.**

Excess demand gives rise to '**inflationary gap**',. It **occurs during expansion** and sets in motion forces that will **cause demand pull inflation.**

The **real output will be constant**, but the rise in the price level will cause an **increase in the nominal output** until the **new equilibrium** is reached at **point E.**

Notes:

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Investment Multiplier

Multiplier refers to phenomenon whereby change in injection of expenditure (investment) leads to proportionately larger change in equilibrium level of NI.

Investment Multiplier (k) explains how many times equilibrium NI increases as result of increase in autonomous investment.

$$K = \frac{\Delta Y}{\Delta I} \text{ or } \frac{1}{1 - MPC} \text{ or } \frac{1}{MPS}$$

MPC is high in underdeveloped countries, but ironically value of multiplier is low. Due to structural inadequacies, increase in consumption exp. is not accompanied by increase in production.

The more powerful leakages are - the smaller will be value of multiplier. The leakages are caused due to:

1. progressive rates of taxation which result in no appreciable increase in consumption despite increase in income
2. high liquidity preference and idle saving or holding of cash balances
3. increased demand for goods met out of existing stocks or through imports
4. additional income spent on purchasing existing wealth or purchase of government securities and shares from shareholders or bond holders
5. undistributed profits of corporations
6. part of increment in income used for payment of debts
7. case of full employment, additional investment will only lead to inflation, and
8. scarcity of goods and services despite having high MPC

Summary of Multiplier

- 2 Sector Model -> $K = 1 / (1 - b)$
- 3 Sector Model
  - If proportional tax (t) is not given -> $K = 1 / (1 - b)$
  - If proportional tax (t) is given -> $K = 1 / 1 - [b(1-t)]$ (Tax Multiplier)
- 4 Sector Model
  - If proportional tax (t) is not given -> $K = 1 / (1 - b + m)$ (Foreign Trade Multiplier)
  - If proportional tax (t) is given -> $K = 1 / 1 - [b(1-t)] + m$

How to solve numericals of equilibrium NI (Y) & multiplier ?

Step 1 : Find Disposable Income (Yd) in terms of $Y = Y - T - t.Y + TR$

Step 2 : Input the above value of Yd in consumption function -> $C = a + b.Yd$

Step 3 : At equilibrium -> AS = AD -> Thus, $Y = C + I + G + (X-M)$

Step 4 : Input value of "C" in above equation & find Y.

Step 5 : Find value of multiplier as per data given in question and the summary on left side.

Import

Import has an autonomous component ($\overline{M}$) and other part is assumed to depend on income(Y). Thus, import function is-

$$M = \overline{M} + mY$$

Marginal propensity to import -> $m = \Delta M / \Delta Y$ ..... is assumed to be constant.

Notes

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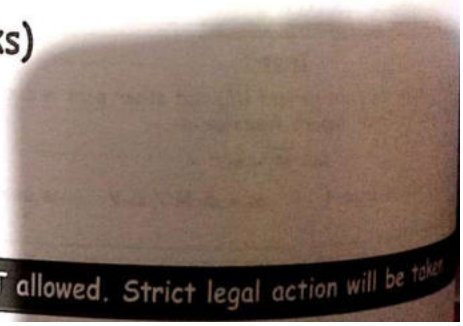
CA Foundation - New Syllabus

Business Economics - Paper 4

SUPER CHART BOOK by MVSIR

Chapter 7
PUBLIC FINANCE

(Weightage: 10 Marks)



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Introduction

Macroeconomics is the study of the economy as a whole. There are three main macroeconomic goals for any nation.

1) The first is economic growth. If the real gross domestic product grows at a faster rate than population → leads to higher standard of living.
2) The second goal is high levels of employment which will ensure higher income and higher output.
3) The third goal is stable price levels.
   Inflation reduces real incomes and purchasing power of some people, and disproportionately affects lower income families.
   Deflation signals a downturn in economic activity which may cause recession and large scale unemployment.

- The government does not expect economy to function automatically; & thus it intervenes to direct them to function in particular directions.
- The objective of the economic system and the role of government is to improve the wellbeing of individuals and households.

The Role of Government in an Economic System

- Basic economic problem of scarcity arises from the fact that wants are unlimited and the resources available to satisfy wants are limited.
- The resources available to any society cannot produce all economic G/S that its members desire to have.
- An **economic system** exists to answer the basic questions like what, how, for whom to produce and how much resources should be set apart to ensure growth of productive capacity.
- **Three Types of economic systems**
  1) Capitalist 2) Socialist 3) Mixed

Adam Smith was a bold advocate of free markets & minimal governmental activity.

Smith believed that govt's roles should be limited, but well defined. As per him, important resource allocation roles of govt.-

a) national defense → protect nation from external violence,
b) establishing a system of justice to provide internal law & order and to protect property
c) establishment & maintenance of public institutions & public works such as roads, bridges, etc. that profit-seeking individuals may not be able to build & operate.

- Richard Musgrave, in his book 'The Theory of Public Finance' (1959), introduced the three-branch taxonomy of the role of government in a market economy
- **Microeconomic functions**
  - ✓ Allocation Function - aims to correct the sources of inefficiency in the economy
  - ✓ Redistribution Function - ensures that the distribution of wealth and income is fair
- **Macroeconomic function**
  - ✓ Stabilization Function- Monetary & fiscal policies , macroeconomic stability problems
- The national budget, in general, reflects the economic policy of a government and the government exercises its economic functions partly through the budget.

Allocation Function

- Resource allocation refers to way in which available resources/factors of production are allocated among various uses.
- It determines how much of G/S will actually be produced in an economy.
- It is a critical problem because resources are limited in supply, whereas wants are unlimited. In addition, resources can have alternative uses.
- **Economic efficiency** indicates a situation in which all resources are allocated to serve each person in best way possible, minimizing waste & inefficiency.
- Resource allocation aims to correct the sources of inefficiency in the economic system.
- If a market is left to itself, it leads to inefficient & misallocation of society's scarce resources. Thus, market failures provide rationale for government's allocative function
- Absence of appropriate government intervention in resource allocation may lead to-

Under-Production or Over-Production of certain goods

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Market failures which hinder efficient allocation of resources occur due to-

1) Imperfect competition and presence of monopoly power
2) Market failure to provide collective goods
3) Markets fail to provi& de the right quantity of merit goods
4) Common property resources are overused and exhausted in individual pursuit of self-interest
5) Externalities
6) Inequalities in distribution of income.
7) Factor immobility which causes unemployment and inefficiency.
8) Imperfect information

- According to Musgrave, the state (govt.) is the instrument by which needs & concerns of citizens are fulfilled.
- Thus, public finance is connected with economic mechanisms that should ideally lead to effective & optimal allocation of limited resources.
- This logic makes it necessary for govt. to intervene in market to bring about improvement in social welfare.

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Allocation Function in Govt. Budgeting determines

a) Who and what will be taxed, &
b) how and on what the government revenue will be spent
c) the process by which total resources of economy are divided among various uses
d) optimum mix of various social goods (both public & merit goods).
e) level of involvement of public sector in economy
f) reallocation of society's resources from private use to public use.

Allocation instruments which govt. can use to influence resource allocation

1) Government may directly produce an economic good
2) Government may influence private allocation through-
   - ✓ Incentives : Tax concessions, Subsidies
   - ✓ Disincentives :Increase in Taxes, Bans
3) Government may influence allocation through its competition policies Eg- Competition Act 2002
4) Governments' regulatory activities such as licensing, minimum wages etc.
5) Government sets legal and administrative frameworks
6) any mixture of above methods

Redistribution Function

The distribution responsibility of govt. arises from the fact that if left to the market, distribution of income among individuals in society is likely to be skewed and thus govt. has to intervene to ensure more socially optimal and egalitarian distribution.

It is related to question of for whom should an economy produce G/S. It also also relates to manner in which effective demand over the economic goods is divided among various individuals of society

Redistributive Function in Govt Budgeting

Expenditure side of budget
Govt. may provide free or subsidised education, healthcare, housing, food etc to deserving people

Revenue side of budget
Redistribution is done through progressive taxation

Aim of Redistribution Function

1) Achieve an equitable distribution of societal output among households
2) Advancing the well-being of those members of the society who suffer from deprivations
3) Providing equality in income, wealth and opportunities
4) Providing security (in terms of fulfilment of basic needs) for people who have hardships
5) Ensuring that everyone enjoys a minimal standard of living

Examples of Redistribution function OR Market intervention for socio-economic reasons

1) Taxation policies- progressive taxation of rich & provision of subsidy to poor households
2) Proceeds from progressive taxes used for financing public services that benefit low-income households
3) Employment reservations to protect certain segments
4) Unemployment benefits & transfer payments to deprived sector
5) Families below poverty line → monetary aid and aid in kind
6) Regulation of mfg. & sale of certain products to ensure well-being
7) Special schemes for backward regions & for vulnerable sections

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Conflict between Efficiency and Equity

Greater equity can be achieved through **high rates of taxes on the rich**;

But high rates of taxes could also act as a **disincentive to entrepreneurship** & work, thus **discouraging people from making savings and investments** & taking risks.

This in turn will have **negative consequences** for economic **output**, **productivity** and **growth** of the economy.

Consequently, **potential tax revenue** may be **reduced** in future and **scope for government's welfare** activities would get seriously **limited**.

Thus, an **optimal budgetary policy** towards any distributional change should **reconcile the conflicting goals** of **efficiency & equity** by exercising an **appropriate trade-off**.

Stabilization Function

Macroeconomic stability is said to exist when:
1) economy's output = production capacity,
2) economy's total spending = total output
3) economy's labour resources are fully employed, and
4) Inflation is low and stable.

Stabilisation function ensures achievement of-
- **macroeconomic stability**,
- maintenance of **high levels of employment** and
- **price stability**.

Rationale of Stabilisation Function

A market economy **does not automatically** generate full employment and price stability & thus, **governments should pursue deliberate stabilization policies**

In absence of intervention by govt, the **instabilities** that occur in economy in form of **recessions**, **inflation** etc. may be **prolonged for longer periods** causing enormous **hardships** to **poorer sections** of society. Also situation of **stagflation** (where inflation & unemployment exist side by side) is possible.

Stabilization issue becomes more complex due to **'contagion effect'** whereby **increased international interdependence** & **financial integration** causes forces of **instability** to get **easily transmitted** from one country to other.

Stabilization function is concerned with performance of aggregate economy in terms of:

1) Labour employment and capital utilisation
2) Overall output and income
3) General price levels
4) Balance of international payments
5) Rate of economic growth

Govt's stabilization intervention may be through

Monetary policy - **Controlling size of money supply** and **interest rate**, which would affect consumption, invt. & prices.

Fiscal policy – It relates to
- **Taxation** decisions &
- **Expenditure** decisions of govt

Which can stimulate economic activities

Expansionary fiscal policy is adopted to alleviate recession

During **recession**, government-
- **increases its expenditure** or
- **cuts down taxes**

in order to ensure income protection,

Contractionary fiscal policy is resorted to for controlling high inflation

During high inflation, government-
- **decreases its expenditure** or
- **increases taxes**

Deficit budgets (Exp > Rev) are expected to **stimulate** economic activity

Surplus budgets (Rev > Exp) tend to **slow down** economic activity.

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Centre and State Finance

Fiscal federalism, a term introduced by **Richard Musgrave**, deals with the division of **governmental functions and financial relations** among the different levels of government.

As per Musgrave, responsibility of-

- central (union/federal) govt → **economic stabilization & income redistribution**, and
- state govt → **allocation of resources**

India is a federation of **28 states & 8 union territories.**

Federalism is an institutional arrangement to accommodate **two sets of government-**

- one at **national level** and
- other at **regional level.**

An **independent judiciary** is established to **resolve disputes** between central government and the states on issues related to **division of power.**

Article 246 of the Constitution of India demarcates the powers of union & state by classifying their powers into three lists-

1) **Union list-** has items on which **union parliament** alone can legislate
2) **State list-** has items on which **state legislative assemblies** alone can legislate
3) **Concurrent list-** has items on which **both** the parliament & legislative assemblies can legislate.

In the event of **conflicting legislation** in concurrent list, the law passed by the **centre** prevails.

- Allocation of revenue & expenditure responsibilities to different levels of govt is a fundamental matter in a federation.
- Sources of revenue for both centre and states are clearly demarcated.
- Taxes are levied by centre & states. Central government has greater revenue raising powers.
- The union government can levy taxes like- income tax, other than agricultural income, customs duties, excise duties, corporation tax, tax on capital value of assets, security transaction tax, central GST, taxes other than stamp duties etc.

- State governments can levy taxes on agricultural income, lands & buildings, mineral rights, electricity, vehicles, tolls, professions, land revenue and impose excise duties on certain items.
- The property of the union is exempt from state taxation. The property and income of the states are not liable to be taxed by the centre.
- There is substantial dependence of states on the union for securing necessary revenues. Articles 268 to 281 of the constitution contain specific provisions in respect of distribution of finances among states.

Distribution of revenue between the union and states is based on the constitutional provisions as follows:

Article 268	**Duties levied by the union but collected and appropriated by the states.**
Article 269	Taxes levied and collected by the union but assigned to the states.
Article 270	Taxes levied and collected by the union and distributed between the union and states as prescribed in clause 2and the States.
Article 271	Surcharge on certain duties and taxes for purposes of the union
Article 275	Statutory Grants – in-aid from the union to certain states.
Article 282	Grants for any public purpose
Article 293	Loans for any public purpose

Finance Commission

A unique feature of **Article 280** → provides for an institutional mechanism, "**Finance Commission**", to facilitate such transfers.

It is responsible for evaluating the state of finances of union & state govt, **recommending the sharing of taxes** between them and **laying down the principles determining the distribution** of these taxes among states.

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The Finance Commission helps in maintaining fiscal federalism in India by performing following functions:

a) Distribution between union & states of net proceeds of taxes & allocation between states.

b) Determination of principles and quantum of grants-in-aid to states.

c) To make recommendations to President on measures needed to augment the consolidated fund of a state to supplement the resources of the panchayats & municipalities in the state on basis of recommendations by Finance Commission of state.

d) Any other matter referred to the Commission by the President in the interests of sound finance.

While recommending transfers, the Finance Commission considers issues-

- **vertical equity** (deciding about the share of all states in revenue collected by centre) &
- **horizontal equity** (allocation among states their share of central revenue).

The Finance Commission broadly assesses the overall gross tax revenues of the union; cesses, surcharges and non-tax revenue are netted out from gross tax revenue to arrive at the net divisible pool (NDP).
[NDP consists of all taxes of union from yr 2000].

Considering the needs of central & state govts, the Commission determines what percentage out of the net divisible pool should be assigned to the state govts. Balance remains with central government.

- The 15th Finance Commission was constituted on 27, Nov 2017
- It recommended the share of states in the central taxes (vertical devolution) for the 2021-26 to be 41%, which is the same as that for 2020-21.
- This is less than the 42% share recommended by the 14th Finance Commission for 2015-20.
- The adjustment of 1% is to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the centre.

Criteria for distribution of central taxes among states for 2021-26 period are same as that for 2020-21. They are:

(a) Income Distance i.e distance of a state's income from state with highest income.
(b) Area
(c) Population (2011)
(d) Demographic performance (to reward efforts made by states in controlling their population)
(e) Forest and ecology
(f) Tax & fiscal efforts

Goods & Service Tax (GST)

- GST was rolled out on 1 July 2017. GST subsumes majority of indirect tax. It made India's indirect tax regime unitary in nature.
- States levy & collect State GST (SGST) & union levies & collects Central GST (CGST). For any particular G/S, SGST & CGST rates are equal.
- Integrated GST (IGST) is applied on inter-state movement of G/S & on imports/exports.
  - ✓ IGST is simply a combination of SGST & CGST
  - ✓ administered & collected by union government,
  - ✓ kept in a separate account,
  - ✓ & distributed between the union & states after settlement of input tax credit and verification of destination of G/S.

- GST accounts for- 35% of gross tax revenue of the union and 44% of own tax revenue of the states.
- As per supreme court verdict in May 2022, Union & state legislatures have "equal, simultaneous and unique powers" to make laws on GST & the recommendations of GST Council are not binding on them.
- GST system replaced old production-based taxation system with a consumption based one. Since manufacturing states had apprehension about loss of revenue, it was decided to provide compensation to states by levying a cess on some luxury goods & demerit goods → proceeds are credited to the compensation fund.
- Top five GST compensation receiving states were Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Punjab. Total amt released during 2022-23 is 115662 cr

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Expenditure Decentralization

In so far as expenditure decentralization is concerned-

- **Central govt** is entrusted with → provision of **nationally important areas** like **defence**, **foreign affairs**, foreign trade and exchange management, money and banking, cross-state transport and communication.
- **State govts** are entrusted with → facilitating **agriculture** & **industry**, providing **social sector services** like health & education, **police protection**, **state roads & infrastructure**.
- The **local self governments** such as **municipalities** and **panchayats** are entrusted with the responsibility of providing **public utility services** such as **water supply** and **sanitation**, **local roads**, **electricity** etc.

For items that fall in the **concurrent list**, **both central & state govts** are responsible for providing services.

Borrowing by Government

Borrowing by Govt of India & borrowing by states → **Article 292 & 293** of Constitution.

- The **centre** may **borrow** within limits fixed by **parliament** by law upon security **of Consolidated Fund of India** or give guarantees within such limits, if any.
- The **state** governments may **borrow** **within territory of India** upon the security **of Consolidated Fund of State** within such limits, if any, fixed by Legislature of such state by law, or give guarantees within such limits.
- The **centre** may **give loans to the states** within limits fixed under article 292 and give guarantees in respect of loans raised by the states.
- **States need to obtain the centre's consent** in order to **borrow** in case the **state is indebted** to the centre over a previous loan.

Notes

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Introduction

- "Market" is an environment where buyers & sellers transact or exchange goods & services.
- Economists presume that people will make choices in their own self-interest, i.e., individuals will behave rationally.
- The general belief is that perfectly working market system is, by default, efficient & effectively allocates scarce economic resources in best possible manner.
- However, this is not always true. Under certain circumstances, 'market failure' occurs

Market failure

It is a situation in which the free market leads to misallocation of society's scarce resources in the sense that there is either-
- > overproduction or
- > underproduction

of particular G/S leading to a less than optimal outcome.

If in all markets perfect competition exist, it leads to market efficiently, most often the prerequisites of competition are unlikely to be present in an economy

Two types of market failure

1) Complete market failure. This is a case of "missing markets" and occurs when the market does not supply products at all despite the fact that such products and services are wanted by people. E.g. Pure public goods.

2) Partial market failure occurs when the market does actually function, but it produces either-
   - wrong quantity of product or
   - at the wrong price.

This results in loss of economic welfare.

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Why do markets fail ? OR Reasons for market failure

I) Market Power | II) Externalities | III) Public Goods | IV) Incomplete Information

I) Market Power

Market power or monopoly power is ability of a firm to profitably raise the market price of a G/S over its marginal cost, thereby earning positive economic profits.

Market power→ cause markets to be inefficient because-
- producers restrict output, &
- keep price higher than Perfect Comp

Thus, market fails to produce right quantity of G/S at the right price. Leading to under-production and thus market failure

II) Externalities

Sometimes, the actions of either consumers or producers result in costs or benefits that do not reflect as part of the market price.

Such costs or benefits which are not accounted for by the market price are called externalities because they are "external" to the market.

Externalities are also referred to as 'spillover effects', OR 'neighbourhood effects' 'third-party effects' OR 'side-effects', as the originator of the externality imposes costs or benefits on others who are not responsible for initiating the effect.

- Since it occurs outside price mechanism, it has not been compensated for, or it is un-internalized or cost (benefit) of it is not borne (paid) by the parties.

- Externalities can be-
- **Negative externalities** occur when the action of one party imposes costs on another party.
- **Positive externalities** occur when the action of one party confers benefits on another party.

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Negative Production Externality

A negative externality
› initiated in production
› which imposes an external cost on others
› may be received by another in consumption or production

NPE received in production
Eg- Factory discharges untreated waste into a nearby river and pollutes water, which affects fish output as there will be less catch for fishermen due to loss of fish

NPE received in consumption
Eg- Factory discharges untreated waste into a nearby river and pollutes the water causing health hazards for people who use the water for drinking and bathing

Negative Consumption Externality

A negative externality
› initiated in consumption
› which imposes an external cost on others
› may be received by another in consumption or production

NCE received in production
Eg- the act of undisciplined students talking and creating disturbance in a class preventing teachers from making effective instruction

NCE received in consumption
Eg- smoking cigarettes in public place causing passive smoking by others

Positive Production Externality

A positive externality
› initiated in production
› that confers external benefits on others
› may be received in production or in consumption.

Compared to NPE, PPE are less common.

PPE received in production
Eg- A firm offers training to its employees for increasing their skills. Firm generates positive benefits for other firms when they hire such workers as they change their jobs.

PPE received in consumption
Eg- When an individual raises an attractive garden and the persons walking by enjoy the garden

Positive Consumption Externality

A positive externality
› initiated in consumption
› that confers external benefits on others
› may be received in production or in consumption

PCE received in production
Eg- Consumption of the services of a health club by employees of a firm would result in an external benefit to firm in form of increased efficiency and productivity

PCE received in consumption
Eg- If people get immunized against contagious diseases, they would confer a social benefit to others as well by preventing others from getting infected

How externalities cause inefficiency and market failure ?

➢ **Private cost** is money cost of production incurred by the firm i.e. wages, raw materials, heating & lighting etc, which must be paid to carry out production, & these which would appear in the firm's accounts.

➢ Supply curve here corresponds to only private marginal costs.

Social costs refer to the total costs to the society on account of a production or consumption activity.

Social costs are
- ❑ **private costs** borne by individuals directly involved in a transaction, **PLUS**
- ❑ **external costs** borne by third parties not directly involved in transaction.

Social Cost = Private cost + External Cost

➢ External costs are not included in firms' costs or consumers' decisions.
➢ But, these external costs are real & important for society.
➢ Firms do not have to pay for damage from pollution which they generate. As a result, each firm's cost, considered for determining output would be only private cost of production & would not incorporate externalities.
➢ The market prices determined without incorporating externalities are not ideal as they do not reflect all social costs and benefits.
➢ Such prices send incorrect signals to producers & consumers → cause either over-production or under-production.
➢ Thus, here a competitive market will produce a level of output which is not socially optimal, leading to market failure.

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III) Public Goods

- Paul A. Samuelson gave the concept of 'collective consumption good' in his paper 'The Pure Theory of Public Expenditure'

- A public good (aka. collective consumption good or social good) is defined as one which-
  - ✓ all enjoy in common
  - ✓ each individual's consumption of such a good leads to no subtraction from any other individuals' consumption of that good.

Characteristics of Public Goods

1) Consumption is collective in nature.

2) Non-Rivalrous : It means that consumption of a public good by one individual does not reduce the quality or quantity available for all other. Eg- if you walk in street light, other persons too can walk without any reduced benefit from the street light

3) Non-excludable : If the good is provided, one individual cannot deny other individuals' consumption, even if they have not paid for it. Eg- national defense once provided, it is impossible to exclude anyone within the country from consuming and benefiting from it.

4) Indivisibility : Each individual may consume all of good i.e. total amount consumed is same for each individual. Eg- national defense, highways, disease prevention and public sanitation etc

5) Once a public good is provided, additional resource cost of another person consuming the goods is 'zero'

6) No direct payment by the consumer is involved

7) More vulnerable to issues such as externalities, inadequate property rights, and free rider problem. There is no incentive for people to pay for the good because they can consume it without paying for it.

If individuals make no offer to pay for public goods, there is market failure in the case of these goods and the profit-maximizing firms will not produce them.

Producers are not motivated to produce public goods, if they cannot charge a positive price for them or make profits from them.

If left to the market, public goods will not be produced at all or will be grossly under-produced. Thus, leading to market failure

Private goods are scarce & anyone who wants to consume them must purchase them at a price.

- They do not face free-rider problem.
- They are 'excludable' i.e. it is possible to exclude or prevent consumers who have not paid for them from consuming them or having access to them.
- Consumption of private goods is 'rivalrous' that is the consumption of it by one individual prevents another individual from consuming it.
- Normally, markets efficiently allocate resources for the production of private goods.
- Eg- food items, clothing, movie ticket, television, cars, etc

IV) Incomplete Information

Perfect information implies that both buyers and sellers have complete information about anything that may influence their decision making.

However, this assumption is not fully satisfied in real markets because of
- complexity of products and services (e.g. cardiac surgery, financial products like mutual funds),
- difficulty of getting correct information, and
- deliberate misinformation by interested parties (e.g. highly persuasive advertisements).

Information failure leads to -
a) asymmetric information,
b) adverse selection and
c) moral hazard
Which affects ability of markets to efficiently allocate resources and therefore lead to market failure because party with better information has a competitive advantage.

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a) Asymmetric Information

Asymmetric Information which means imbalance in information, i.e when seller knows more than buyer or vice versa. This can distort choices and lead to market failure.

For eg,
- the landlords know more about their properties than the tenants,
- a borrower knows more about their ability to repay a loan than the lender,
- a used-car seller knows more about the vehicle quality than the buyer,
- health insurance buyers know more about their state of health than the insurance companies and
- some traders may possess insider information in financial markets.

b) Adverse Selection

Asymmetric information generates adverse selection.

When one party to a contract, say X, possesses information relevant to the contract that other party Y does not have, the expected value of the transaction is known more accurately to X due to asymmetry of information. Then, X (having more information) may take advantage Y's ignorance and this could put the ignorant party Y at a loss

Thus, asymmetric information leads the party lacking relevant knowledge to make sub-optimal decisions and suffer adverse effects.

For example, insurers know less about health conditions of buyers and are therefore unable to differentiate between high-risk and low-risk persons. This forces the price of insurance to rise, so that more healthy people, aware of their low risks, choose not to be insured. It also further increases the proportion of unhealthy people among the insured, thus raising the price of insurance up more.

Lemons Problem (given by George Akerlof)

The owner of a car knows much more about its quality than anyone else. While placing it for sale, he may not disclose all that he knows about the mechanical defects of the vehicle.

Based on the probability that the car on sale is a 'lemon', the buyers' willingness to pay for any particular car will be based on the 'average quality' of used cars. Not knowing the honesty of the seller means, the price offered for the vehicle is likely to be less than that of a good car, to account for this risk.

However, anyone who sells a 'lemon' (an unusually poor car) stands to gain. If buyers were aware as to which car is good, they would pay the price they feel reasonable for a good car.

Since the price offered in the market is lower than the acceptable one,good car sellers will not be inclined to sell. The market becomes flooded with 'lemons' and eventually the market may offer nothing but 'lemons'. The result is market distortion with lower prices and lower average quality of cars.

Thus, asymmetric information leads to elimination of high-quality goods from the market. Economic agents end up either selecting a sub-standard product (lemon) or leaving the market altogether.

c) Moral Hazards

Moral hazard arises whenever there is an externality (i.e., whenever an economic agent can shift some of its costs to others). It is about informed person's taking advantage of a less-informed person through an unobserved action.

It occurs when one party to an agreement knows that he need not bear the consequences of his bad behaviour and that the consequence, if any, would be borne by the other party. Therefore, he engages in risky behaviour or fails to act in good faith

For eg, a driver who has a comprehensive insurance tends to exhibit greater taste for risk-taking in getting to his destination quickly & hence his interests contradict with those of insurer. This causes insurance premiums to rise for everyone, driving many potential customers out of market.

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I) Minimize Market Power | II) Correct Externalities | III) Merit & Demerit Goods | IV) Government intervention in case of Public goods | V) Price intervention: non-market pricing | VI) Correcting Information Failure | VII) Equitable Distribution

I) Minimize Market Power

Market power contributes to inefficiency because it tends to restrict output which results in higher prices thus leading to deadweight loss.

Because of the social costs imposed by monopoly, governments intervene by establishing rules and regulations designed to promote competition and prohibit actions that are likely to restrain competition.

These legislations differ from country to country.
India- Competition Act, 2002 ;
USA- Antitrust Laws

Other measures include:

1) Market liberalisation by introducing competition in previously monopolistic sectors such as energy, telecommunication etc.
2) Controls on mergers and acquisitions if there is possible market domination.
3) Patronage to consumer associations
4) Tough investigations into cartelisation and unfair practices such as collusion and predatory pricing
5) Reduction in import controls
6) Nationalisation
7) Price capping and price regulation
8) Restrictions on monopsony power of firms
9) Profit or rate of return regulation - Govt's regulatory agency determines an acceptable price, so as to ensure a competitive or fair rate of return. This practice is called rate-of return regulation.

II) a) Government intervention to correct Negative Externalities

Direct Controls | Market Based Policies

Direct Controls

Direct controls, (aka command solutions), prohibit activities that create negative externalities or require that negative externality be limited to a certain level.

For example,

- Limiting amount of pollutants released into water & air by firms or make it mandatory to use pollution control devices.
- Licensing, production quotas and mandates regarding acceptable production processes.
- Production, use and sale of some commodities can be banned. Eg- Smoking at public places
- Pass laws to alleviate effects of negative externalities. Eg- Environment (Protection) Act, 1986
- The government may, through legislation, fix emissions standard which is a legal limit on how much pollutant a firm can emit. If firm exceeds limit, it can invite monetary penalties.
- The firms have to install pollution-abatement mechanisms to ensure adherence to the emission standards. This means additional expenditure to the firm leading to rise in the firm's average cost.
- Charge an emissions fee which is levied on each unit of a firm's emissions.
- Form special bodies/ boards to specifically address the problem: for eg Ministry of Environment & Forest, Pollution Control Board of India etc

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Market Based Policies

Market-based policies provide economic incentives so that self interest of market participants would achieve the socially optimal solution.

The market based approaches focus on generation of a market price for pollution, achieved by-

> Setting price directly- by pollution tax

> Setting price indirectly- by cap-&-trade system

The key to internalizing an externality (both external costs and benefits) is to ensure that those who create the externalities include them while making decisions. (Pollution Tax)

Second approach to establishing prices indirectly is 'tradable emissions permits'. (carbon credits)

Pollution Tax

The size of pollution tax depends on the amount of pollution a firm produces.

Aka. Pigouvian taxes after A.C. Pigou

These taxes, by 'making the polluter pay', seek to internalize the external costs into the price of a product or activity.

Tax increases the private cost and thus decreases output of good which creates negative externality.

The proceeds from the tax, can be used for projects that protect or enhance environment.

Problems in administering an efficient pollution tax

1) Pollution taxes are difficult to determine & administer as it involves use of complex & costly administrative procedures for monitoring the polluters.
2) If demand for the good is inelastic, tax may have only an insignificant effect in reducing demand. In such cases, the producers will be able to easily shift the tax burden in the form of higher product prices.
3) Pollution taxes also have potential negative consequences on employment and investments because high pollution taxes in one country may encourage producers to shift their production facilities to those countries with lower taxes.

Tradable Emission Permits

- The use of tradable permits to limit emissions is often called 'cap and trade'.
- A tradable permit is a license that allows a company to release a unit of pollution into the environment over some period of time. By issuing a fixed number of permits, the government determines the total level of pollution that can be legally emitted during each period (the 'cap').
- Each firm has permits specifying the number of units of emissions that the firm is allowed to generate. A firm that generates emissions above what is allowed by the permit is penalized with substantial fines.
- The firms can sell their government-issued permits to other firms. Since the permits are tradable (the firm can sell for a price), a polluting firm faces an opportunity cost i.e. for each unit of pollution that it creates, it must either buy a permit, or it must forgo the revenue it could earn by selling the permit to some other firm. A firm which produces less pollution can sell their permits and earn money.
- The high polluters have to buy more permits, which increases their costs, and makes them less competitive and less profitable. The low polluters receive extra revenue from selling their surplus permits, which makes them more competitive and more profitable. Thus, firms will have incentive not to pollute.
- In 1994, USA began a cap & trade system for sulphur dioxide emissions that cause acid rain by issuing permits to power plants based on their historical consumption of coal.
- In India, the Perform, Achieve & Trade (PAT) scheme, carbon tax in the form of a cess on coal, lignite and peat, Renewable Purchase Obligations (RPO) etc. In 2017, coal cess was abolished and replaced by the GST compensation cess.
- The Energy Conservation (Amendment) Bill, 2022 empowers the central government to specify a carbon credit trading scheme and to stipulate energy consumption standards.

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II) b) Government intervention to correct Positive Externalities

Though positive externality is associated with external benefits, we still call it a market failure because, left to market, there will be less than optimal output.

Since positive externalities promote welfare, governments implement policies that promote positive externalities.

When positive externalities are present, government may attempt to solve the problem through -

a) corrective subsidies to the producers aimed at increasing the supply of the good. (Eg- fertilizer subsidy)
b) corrective subsidies to consumers aimed at increasing the demand for the good. (Eg- A subsidy on fee for education is an example of consumption subsidy)

- As we are aware, a corrective production subsidy involves government paying part of the cost to the firms to promote the production of goods having positive externalities. This is in fact a market-based policy as subsidies to producers would lower their cost of production.
- In the case of goods whose externalities are vastly positive, government enters the market directly as an entrepreneur to produce & provide them. Eg- Public education, health care etc.
- Governments also engage in direct production of environmental quality. Eg- afforestation, reforestation, protection of water bodies, treatment of sewage and cleaning of toxic waste sites.

III) a) Government intervention in case of merit goods

- **Merit goods** are goods that have substantial positive externalities & hence are socially desirable.
- Merit goods can be provided through market, but are likely to be under-produced and under-consumed through the market mechanism so that social welfare will not be maximized.
- **Eg**- education, health care, welfare services, housing, fire protection, waste management, public libraries, museum and public parks etc
- The possible government responses to under-provision of merit goods are- regulation, subsidies, direct government provision and a combination of government provision and market provision.

1) **Regulation** determines how a private activity may be conducted. Eg, the way in which education is to be imparted is government regulated.

2) Govt can prohibit some type of goods and activities, set standards and issue mandates making others oblige. Eg, govt may make it compulsory to avail insurance protection, compulsory vaccination etc

3) Govt could also use legislation to enforce consumption of a good which generates positive externalities. E.g. use of helmets, seat belts etc.

4) Govt can compel individuals to consume a good that generates the external benefit. The Right of Children to Free and Compulsory Education Act, 2009 which mandates free & compulsory education for every child of the age of 6 to 14 years.

5) The ultimate encouragement to consume is to make the good completely free at the point of consumption: for example freely available hospital treatment for various diseases. When merit goods are directly provided free of cost by government, there will be substantial demand for the same.

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III) b) Government intervention in case of demerit goods

- Demerit goods are socially undesirable. Eg- cigarettes, alcohol, intoxicating drugs etc. The consumption of demerit goods imposes negative externalities on society as a whole.
- The production and consumption of demerit goods are likely to be more than optimal under free markets.
- The price that consumers pay for a packet of cigarettes is market determined and does not account for the social costs that arise due to externalities.
- However, it should be kept in mind that all goods with negative externalities are not essentially demerit goods; e.g. Production of steel causes pollution, but steel is not a socially undesirable good.

How do governments correct market failure resulting from demerit goods ?

1) Enforce complete ban on a demerit good. e.g. Intoxicating drugs
The effect of stringent regulation such as total ban is seldom realized in form of complete elimination of demerit good; conversely such goods are secretly driven underground and traded in a hidden market

2) Imposing unusually high taxes
But, demand for demerit goods like, cigarettes & alcohol is often highly inelastic, so any increase in price resulting from additional tax causes a less than proportionate decrease in demand. Also, sellers can always shift the taxes to consumers without losing customers.

3) Government can fix a minimum price below which the demerit good should not be exchanged. The effect of such minimum price fixation above equilibrium price

4) Through persuasion, achieved by negative advertising campaigns which emphasize the dangers with consumption of demerit goods Eg- Mukesh- iss shehar ko ye hua kya hai

5) Through legislations that prohibit the advertising or promotion of demerit goods Eg- Alcohol ads- music cds

6) Strict regulations- to limit access to good, especially by vulnerable groups such as children and adolescents

7) Spatial restrictions e.g. smoking in public places, sale of tobacco to be away from schools

IV) Government intervention in case of Public goods

- Direct provision of a public good by government can help overcome the free-rider problem which leads to market failure.
- Important public goods- Eg- defence, establishment & maintenance of legal system, disease prevention etc are invariably provided by the government.
- Excludable public goods can be provided by government and the same can be financed through entry fees. Grant licenses to private firms to build a public good facility. Under this method, goods are provided to the public on payment of an entry fee. Government regulates level of the entry fee chargeable from public and keeps strict watch on the functioning of licensee to guarantee equitable distribution of welfare.
- Some public goods are provided by voluntary contributions and private donations by corporate entities and NGOs.
- Certain goods are produced and consumed as public goods and services despite the fact that they can be produced or consumed as private goods. As, left to the markets and profit motives, these may prove dangerous to society.Eg-
  - scientific approval of drugs,
  - production of strategic products such as atomic energy,
  - provision of security at airports etc

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V) Price Intervention: Non-Market Pricing

Price intervention → form of price controls which are **legal restrictions on price.**

Price controls may take the form of either-

- ☐ **Price Floor** (a minimum price buyers are required to pay) or
- ✓ Eg- **Minimum Support Price (MSP)**, to guarantee steady and assured incomes to farmers.

- ☐ **Price Ceiling** (a maximum price sellers are allowed to charge)
- ✓ Eg- **Fixing of minimum wages** & **rent controls**
- ✓ When **prices of certain essential commodities rise excessively**, government may resort to controls in the form of **price ceilings** (also called maximum price) for making a resource or commodity available to all at reasonable prices. Eg- **maximum prices of food grains** and essential items are set by government during times of **scarcity**

VI) Correcting Information Failure

1) Government makes it mandatory to have **accurate labelling** and **content disclosures** by producers. Eg. Labelling on cigarette packets and **nutritional information** in food packages.

2) **Mandatory disclosure** of information Eg: **SEBI** requires that accurate information be provided to prospective buyers of new stocks.

3) **Public dissemination of information** to improve knowledge and subsidizing of initiatives in that direction

4) **Regulation of advertising** and setting of advertising **standards** to make advertising more responsible, informative and less persuasive.

VII) Equitable Distribution

One of the most important activities of government is to redistribute incomes so that there is **equity and fairness in the society.**

Some common policy interventions include

1) **progressive** income tax,
2) **targeted budgetary allocations**
3) **unemployment** compensation
4) **transfer payments, subsidies,** social security schemes, job **reservations,** etc.

Government Failure

- Government failures where government intervention in the economy to correct a market failure creates inefficiency and leads to a misallocation of scarce resources occur very often.
- Government failure occurs when:
  1. **intervention is ineffective** causing wastage of resources expended for the intervention
  2. **intervention produces fresh and more serious problems**

There are costs and benefits associated with any government intervention in the market, and it is important that policy makers consider all the costs and benefits of a policy intervention.

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I) Basics

- Governments all over the world have to perform manifold functions from protecting their territories, maintaining law and order, provision of public goods and implementation of comprehensive plans for economic & social welfare of its citizens.
- To execute these functions efficiently, the government requires adequate financial resources. Budget is a powerful policy instrument in the hands of government to regulate and to restructure a country's economic priorities.

- The need for budgeting arises from the need to efficiently allocate limited resources to ensure maximum social welfare.
- The government also needs to reallocate resources in accordance with its declared priorities. By proper budgeting, the government is able to ensure redistribution of income and wealth.
- The other objectives of budgets are reduction/ elimination of economic fluctuations to bring in stability, sustainable increase in real GDP and reduction in regional disparities.
- In simple terms, a budget is a statement that presents the details of
  - 'where the money comes from' and
  - 'where the money goes to'.

- The government budget is a document presented for approval and legislation by a government and contains estimates of the proposed expenditure for a given period and the proposed means of financing them.
- The budget includes projections for the economy and its various sectors such as agriculture, industry, and services.
- The budget also contains estimates of the government's accounts for the next fiscal year called budgeted estimates.
- Being the document which consolidates revenues from all sources and outlays for all activities, the budget is the most comprehensive report of the government's finances.
- Apart from union budget, state and local bodies have their own budgetary processes for the next financial year. However, the focus of this unit will be the union budget only.

II) The Process Of Budget Making

- The budgetary process is the means by which the executive and legislative branches together formulate a coherent set of taxing and spending proposals. The finances of the government of India have traditionally been controlled by the Ministry of Finance. The budget is prepared by the Ministry of Finance in consultation with NITI Aayog and other relevant ministries. The budget must be presented and approved by both houses of parliament before the beginning of the fiscal year (April 1 to March 31).

- Despite the fact that the term 'budget' has not been used in the Indian Constitution, the process of making it is referred to as budgeting.
- Article 112 of the constitution provides that in respect of every financial year the 'president shall cause to be laid before both the houses of parliament a statement of the estimated receipts and expenditure of the government of India for that year, referred to as the "Annual Financial Statement".

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The budgetary procedures are -
(i) Preparation of the budget
(ii) Presentation and enactment of budget and
(iii) Execution of the budget.

The budget process mainly consists of two types of activities:
1. The administrative process, wherein the budget along with the accompanying documents are prepared in consultation with various stakeholders;
2. The legislative process wherein the budget is passed by the parliament after discussions.

- Despite the fact that the union budget is presented on 1st February (or any other suitable date as decided by the government), the process of budget preparation commences in August-September of the previous year. Budget Division of the Ministry of Finance prepares a comprehensive schedule for carrying out budget preparation activities.
- The process of budget making is set off with the Budget Division issuing the budget circular containing detailed instructions and formats for preparing the estimates to all ministries, states, union territories and autonomous bodies.

- The detailed estimates of expenditure are prepared by ministries and departments according to their assessment of requirements for the subsequent year. Every department prepares estimates for receipts and expenditure separately.
- A series of pre-budget consultations are done by the union finance minister with the finance ministers and chief ministers of states, various stakeholders and interest groups including industry associations, representatives from agriculture and social and welfare sectors, labour organisations, experts from NITI Aayog, economists etc. to elicit their suggestions on the proposed budget.

The budget is presented in the Parliament in such form as the Finance Ministry may decide after considering the suggestions (if any) of the Estimates Committee. Broadly, the **budget documents depict information relating to receipts and expenditure for two years. They are:**
(i) Budget estimates (BE) of receipts and expenditure in respect of current and ensuing financial year
(ii) For the current year through Revised Estimates (RE); and
(iii) Actuals of the year preceding current year

The budget speech is mainly a policy document which draws attention to the proposed policies and programmes of the government. The finance minister makes a detailed budget speech at the time of presenting the budget before the Lok Sabha.

The budget speech present details of the proposals for the new financial year regarding taxation, borrowings and expenditure plans of the government.

Budget speech is usually in two parts.
- Part A of the budget speech gives an outline of the prevailing macro economic situation of the country and the budget estimates for the next financial year. Elaborating the priorities of the government, the minister presents a broad framework of the total funds raised by the government via taxes or borrowings, proposed government expenditure allocations for different sectors and fresh schemes for different sectors.
- Part B of the budget speech details the progress the government has made on various developmental measures, the direction of future policies and the government's tax proposals for the upcoming financial year including variations in the current taxation system.

Annual Financial Statement shows receipts & exp. of govt. in 3 separate parts under which govt. accounts are maintained, namely:
1. Consolidated Fund of India
2. Contingency Fund of India, &
3. Public Account.

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The list of budget documents presented to the parliament, besides the finance minister's budget speech, is given below:

(a) Annual Financial Statement (AFS)
(b) Demands for Grants (DG)
(c) Finance Bill
(d) Statements mandated under FRBM Act:
   i. Macro -Economic Framework Statement
   ii. Medium-Term Fiscal Policy cum Fiscal Policy Strategy Statement

Nine other documents which are in the nature of explanatory statements supporting the mandated documents are also presented along with the documents mentioned above.

The expenditures of certain categories (e.g. the emoluments and allowances of the President of India and his/her office, and emoluments of Judges of supreme courts and high ranking personnel of constitutional bodies across India) are 'charged' on the Consolidated Fund of India and are not subject to the vote of parliament, are also indicated separately in the budget.

By convention in an election year, the budget may be presented twice.

- The first one is to first to secure a Vote on Account for a few months.
- This is followed by the Annual financial statement for that year or the full-fledged Budget.

The budget is discussed in two stages in the Lok Sabha. First, there is the general discussion on the budget as a whole. After the first stage of general discussion on the union budget is over, the house is adjourned for a fixed period. During this period, the demands for grants of various ministries/ departments are considered by the standing committees concerned, and once the reports are presented by these committees within the stipulated time, the house proceeds to discussion and conducts ministry-wise voting on demands for grants.

- The Lok Sabha has the power to concur or to refuse any demand or even to reduce the amount of grant sought by government. The budget is laid on the table of the Rajya Sabha soon after the Finance Minister has completed her/his budget speech in the Lok Sabha. The Rajya Sabha, does not vote on the demands for grants and there is only a general discussion on the budget.
- After the general discussion on the budget proposals and voting on demands for grants have been completed, the government introduces the Appropriation Bill. The Appropriation Bill is intended to give authority to government to incur expenditure from and out of the Consolidated Fund of India.

- Motions for reduction to various demands for grants are made in the form of 'cut motions' seeking to reduce the sums sought by government.
- The Finance Bill seeking to give effect to the government's taxation proposals is introduced in Lok Sabha immediately after the presentation of the general budget. It is accompanied by a memorandum explaining the provisions of the bill and their effect on the finances of the country. The motion for leave to introduce a finance bill cannot be opposed. The finance bill is taken up for consideration and passing after the Appropriation Bill is passed. The finance bill seeks to give effect to the financial proposals of the government for the next financial year. The Parliament has to pass the Finance Bill within 75 days of its introduction.
- On the last day of the days allotted for discussion on demands for grants, the speaker puts all the outstanding demands for grants to the vote of the house. This process is known as 'Guillotine'. It is a device for bringing the debate on financial proposals to an end within a specified time.

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- After the Finance Bill has been passed by the Lok Sabha, it is transmitted to the Rajya Sabha for Its recommendations.
- The bill being a money bill, Rajya Sabha has to return it within a period of 14 days, with or without recommendations. The recommendations of Rajya Sabha may be accepted or rejected by the Lok Sabha.

However from 2017-18, the date of presentation of the budget has been advanced to 1st February. An important budgetary reform was the merger of railway budget with the general budget from the budget for financial year 2017-18.

Notes

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III) Sources of Revenue

The Department of Revenue of the Ministry of Finance exercises control in respect of the revenue matters relating to direct and indirect union taxes. The department is also entrusted with the administration and enforcement of regulatory measures provided in the enactments concerning goods and services tax (GST), central sales tax, stamp duties and other relevant fiscal statutes. The

The **Department of Revenue** exercises control in respect of matters relating to all the **direct and indirect union taxes through two statutory boards**, namely,

1. the Central Board of Direct Taxes (CBDT) and
2. the Central Board of Indirect Taxes and Customs (CBIC).

Matters relating to the levy and collection of all direct taxes are looked after by the CBDT whereas those relating to levy and collection of goods and service taxes (GST), Customs and central excise duties, service tax and other Indirect taxes fall within the purview of the CBIC.

Government receipts are classified under two categories:

1. Revenue receipts which consists of tax revenue and non tax revenue.
2. Capital receipts which consists of debt receipts and non debt capital receipts

The **broad sources of revenue are:**

1. Corporation tax
2. Taxes on income
3. Wealth tax
4. Customs duties
5. Union excise duties
6. Goods and services tax including GST compensation cess
7. Taxes on union territories

Centre's net tax revenue is the total of tax revenue after paying of the states' share and the National Calamity Contingent duty (NCCD) transferred to the National Calamity Contingency. **Non-tax revenues comprise the following:**

1. Interest receipts,
2. Dividends and profits from public sector enterprises and surplus transfers from Reserve Bank of India
3. 3. Other Non-tax revenues and
4. 4. Receipts of union territories

Various social services provided by the government such as medical services, public health: broadcasting, education, sports, art and culture, housing: and economic services such as communication, energy, transport, science, technology and environment, railways and general administrative services also yield revenue for the government. **Capital Receipts include:**

1. Non debt capital receipts which include
   (a) Recoveries of loans and advances
   (b) Miscellaneous capital receipts (disinvestments and others)
2. Debt capital receipts which include
   a) Market loans for different purposes
   b) Short term /Treasury bill borrowings
   c) Securities issued against small savings,
   d) State provident fund (Net)
   e) Net external debts
   f) Other receipts (Net)

- In short, non debt receipts include recoveries of loans advanced by the government to PSEs, state governments, foreign governments and union territories and sale proceeds of government assets, including those realized from divestment of government equity in public sector undertakings (PSUs).
- Debt capital receipts comprise of market loans and short term borrowings by the government, borrowing from the Reserve Bank of India and loans taken from foreign governments/institutions.
- Examples of 'Other receipts' include Sovereign Gold Bond Scheme, receipts from international financial institutions and saving bonds.

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IV) Public Expenditure Management

- In view of the limited nature of resources, a prudent and well designed public expenditure management is essential for any government to ensure that the **level of aggregate public expenditure** is **consistent** with a **sustainable macroeconomic framework.**
- Developing economies like India require enormous amount of public spending to initiate and accelerate economic growth and to promote employment opportunities. **Effective reduction in fiscal deficit** requires an **ingenious mix of revenue and expenditure policies.**
- Government expenditure affects allocation of resources among various uses and therefore, great care should be taken to **channelize the resources to socially desirable areas.**

Public expenditure management is the process that allows governments to be fiscally responsible. Public expenditure programmes or projects should be designed and implemented to provide given levels of outputs or achieve specific objectives at minimum cost.

The economic costs of unproductive public expenditures can be extensive .and may have far reaching effects such as:

- larger deficits
- higher levels of taxation,
- lower economic growth,
- fewer resources available for use elsewhere, and
- greater debt burden in the future.

The **Department of Expenditure of the Ministry of Finance** is the nodal department for overseeing the public financial management system in the central government and matters connected with state finances. It is **responsible for**

- the **implementation** of the **recommendations** of the **Finance Commission** and the Central Pay Commission,
- **monitoring of audit comments/observations**, and
- **preparation of central government accounts.**
- Additionally, it also assists central **ministries/departments** in **controlling the costs** and **prices of public services,**
- **reviewing systems and procedures** to optimize outputs and outcomes of public expenditure.

- The requirements of funds for all categories of expenditure including various programmes and schemes, along with receipts of the departments are discussed during the pre-budget meetings chaired by Secretary (Expenditure).
- Expenditure estimates are **provisionally finalized** and **communicated to ministries/departments** after the **approval of Finance Minister.**
- One of the explanatory documents of the budget document is the **'Expenditure Profile'** (earlier known as expenditure budget) consisting of relevant data across all ministries/departments to outline a profile of the general financial performance of the government of India.
- It gives an aggregation of various types of expenditure and certain other items across demands.

Notes:

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The total expenditure through budget (both current and capital) of various ministries and departments is composed of central expenditure and transfers.

In **Expenditure budget**, the **Central government expenditure is classified into six broad categories** as below:

A. Centre's Expenditure:

- Establishment Expenditure of the Centre;
- Central sector schemes, and
- Other central expenditures including those on CPSEs and Autonomous Bodies

B. Centrally Sponsored Schemes and other Transfers:

The transfers include

- Centrally sponsored schemes
- Finance Commission transfers and
- Other transfers to states

Establishment expenditure includes establishment-related expenditure of the ministries/departments, and attached and subordinates offices. Central Sector Schemes (CS) include those schemes which are entirely funded and implemented by the central agencies under union government ministries/departments.

IV) Public Debt Management

- In emerging market and developing economies, the government is generally the largest borrower. Government debt from internal and external sources contracted in Consolidated Fund of India is defined as Public Debt.
- The government raises funds primarily from the domestic market using market-based and fixed-rate instruments to finance its fiscal deficit.

- Public debt, in simple words, means debt incurred by the government in mobilizing savings of the people in the form of loans, which are to be repaid at a future date with interest. Public debt is not a one-time exercise of borrowing and repaying.
- Debt servicing is a continuous exercise as a portion of debt falls due each month, government does not usually cut expenditure or raise taxes to provide funds to retire or repay the maturing bonds. Rather, the government simply refinances the debt, i.e. it sells new bonds and uses the proceeds to pay off holders of the maturity bonds.
- Hence public debt management becomes a crucial task or responsibility of the government and plays an important role in macroeconomic stability of a country.

Productive use of public debt contributes to economic growth and welfare of the society. Sustainability of sovereign debt has always been an important indicator of the overall macroeconomic health of a country. Debt sustainability is in great part a function of the level of debt and the government's capacity to service the outstanding debt.

- **Public debt management** refers to the task of determining, by the fiscal and monetary authorities, the size and composition of debt, the maturity pattern, interest rates, redemption of debt etc. It is the process of setting up and implementing the strategy for managing public debt in order to raise the required amount of funding at the desired risk and cost levels.
- **The overall objective of the central government's debt management policy** is to "meet the central government's financing needs at the lowest possible long term borrowing costs and also to keep the total debt within sustainable levels. Additionally, it aims at supporting development of a well-functioning and vibrant domestic bond market".
- Keeping in view the increasing magnitude of public borrowing both internal and external, the extent to which the government can mobilise funds from public depends upon the skilful public debt management.
- **Debt management strategy is based on three broad pillars namely,**
  i. low cost of borrowing,
  ii. risk mitigation and
  iii. market development.

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The institutions responsible for public debt management are:

1. Reserve Bank of India - domestic marketable debt i.e., dated securities, treasury bills and cash management bills.
2. Ministry of Finance (MOF); - external debt
3. Ministry of Finance; Budget Division and Reserve Bank of India - Other liabilities such as small savings, deposits, reserve funds etc.

The responsibility of managing the domestic debt of the central government and of 28 state governments and two union territories is entrusted with the Internal Debt Management Department (IDMD) of the Reserve Bank of India. **The RBI acts as the debt manager for marketable internal debt.** While treasury bills are issued to meet short term cash requirements of the government, dated securities are issued to mobilise longer term resources to finance the fiscal deficit. From 1997 onwards, the Reserve Bank also provides short-term credit up to three months to state governments banking with it in the form of Ways and Means Advances (WMA) to bridge temporary mismatches in cash flows.

- External debt (bilateral and multilateral loans) is managed by the Department of Economic Affairs in the Ministry of Finance (MoF).
- Most of the external debt is sourced from multilateral agencies (International Bank for Reconstruction and Development, Asian Development Bank, etc.).
- **The risk associated with external the debt is the depreciation in the value of domestic currency vis-à-vis the currency of denomination of external loans leading to increase in the government's debt servicing cost.**

The Fiscal Responsibility and Budget Management (FRBM) was passed in 2003 to provide a legislative framework for reduction of deficit and thereby debt of the central government to a sustainable level. **The objectives of the act are:**

- **inter-generational equity in fiscal management,**
- **long run macroeconomic stability,**
- **better coordination between fiscal and monetary policy, and**
- **transparency in fiscal operation of the government.**

The Public Debt Management Cell (PDMC) was created in 2016 under the Department of Economic Affairs. The Medium Term Debt Management Strategy or MTDS 2021-24 is a framework to determine the appropriate composition of the debt portfolio. The objective of the debt management strategy is to efficiently raise debt at the lowest possible cost in the medium term while ensuring that financing requirements are met without disruption.

The sheer size of India's public debt can be understood from the following table:

	As on 31st March 2023	As on 31st March 2024
Internal debt and other liabilities	147,77,724.43	164,23,983.04
External debt#	4,83,397.69	5,22,683.81
Total	152,61,122.12	169,46,666.85

In line with the global trend, the government of India also responded to the pandemic challenges and increased its expenditure on health and social sector. At the same time, the revenue receipts declined substantially due to the adverse effects of the pandemic on economic activity.

Consequently, fiscal deficit widened necessitating an increase in the size of the borrowing programme significantly during 2020-21 and 2021-22 in order to render counter-cyclical fiscal policy support and to provide targeted support to segments deeply hit by the pandemic.

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The Reserve Bank has been proactively engaged in the development of the government securities (G-sec) market including broadening of investor participation. As part of continuing efforts to **increase retail participation in G-sec, 'RBI Retail Direct' facility was announced on February 5, 2021:**

- ❑ for improving the ease of access by retail investors through online access to the primary and secondary government securities market
- ❑ to provide the facility to open their government securities account ('Retail Direct') with the Reserve Bank.

Budget concepts

Type of budgets

Balanced budget: - A balanced budget is a budget in which revenues are equal to expenditures. Thus, neither a budget deficit nor a budget surplus exists. Revenue does not fall short of expenditure. i.e., revenue is equal to expenditure (Revenue = Expenditure).

Unbalanced budget : The budget may either be surplus or deficit.

- **A surplus budget:** when estimated government receipts are more than the estimated government expenditure it is termed as surplus budget. When the government spends less than the receipts the budget becomes surplus. Briefly put, public revenue exceeds public expenditure (R>E.)
- **A deficit budget:** when estimated government receipts are less than the government expenditure, it is termed as a deficit budget. A deficit budget increases the liability of the government or decreases its reserves. In modern economies, most of the countries follow deficit budgeting.

Capital receipts

Capital receipts are those receipts that lead to a reduction in the assets or an increase in the liabilities of the government. Examples include recoveries of loans, earnings from disinvestment and debt.

Revenue Receipts

Revenue receipts can be defined as those receipts which neither create any liability nor cause any reduction in the assets of the government. There are two sources of revenue receipts for the government – tax revenues and non-tax revenues.

Revenue Receipts

Revenue expenditure is expenditure incurred for purposes other than creation of physical or financial assets of the central government. It relates to those expenses incurred for the normal functioning of the government departments and various services, interest payments on debt incurred by the government, and grants given to state governments and other parties (even though some of the grants may be meant for creation of assets).

Capital Expenditure

There are expenditures of the government which result in creation of physical or financial assets or reduction in financial liabilities. This includes expenditure on the acquisition of land, building, machinery and equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties.

When a government spends more than it collects by way of revenue, it incurs a budget deficit. There are various measures that capture government deficit and they have their own implications for the economy.

Budgetary Deficit or Overall Deficit

Budgetary Deficit is defined as the excess of total estimated expenditure over total estimated revenue is difference between all receipts and expenditure, both revenue and capital.

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Revenue Deficit

The revenue deficit refers to the **excess of government's revenue expenditure over revenue receipts.** It shows the shortfall of government's current receipts over current expenditure. It shows the government revenue is insufficient to meet the regular expenditures in connection with the normal functioning of the government, or the government is diverting resources from other sectors to finance its current expenditure.

Revenue deficit = Revenue expenditure - Revenue receipts

Fiscal Deficit

When the government's non-borrowed receipts fall short of its entire expenditure, it has to borrow money from the public to meet the shortfall. **The excess of total expenditure over total receipts excluding borrowings during a given fiscal year is called the fiscal deficit.** In other words, fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing. It is often presented as a percentage of the gross domestic product (GDP).

Total Receipts excluding borrowing = Revenue Receipts + Capital Receipts excluding borrowing or (Non debt creating capital receipts). Non debt creating capital receipts include recoveries of loans advanced by the government and sale proceeds of government assets, including those realized from divestment of government equity in public sector undertakings (PSUs).

Fiscal deficit = Total Expenditure -Total Receipts excluding borrowing

- Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) - (Revenue Receipts + Capital Receipts excluding borrowing)
- Fiscal Deficit = (Revenue Expenditure- Revenue Receipts) + (Capital Expenditure - Capital Receipts excluding borrowing)
- Fiscal Deficit = Revenue Deficit + (Capital Expenditure - Capital Receipts excluding borrowing)

The fiscal deficit will have to be financed by borrowing. Therefore fiscal deficit points to the total borrowing requirements of the government from all sources. In case revenue deficit occupies a substantial share of fiscal deficit, it is an **indication that a large part of borrowing is used for consumption purposes rather than for investment.**

Primary Deficit

Primary deficit is defined as **fiscal deficit of current year minus interest payments on previous borrowings.** In other words whereas fiscal deficit indicates borrowing requirement inclusive of interest payment, primary deficit indicates borrowing requirement exclusive of interest payment. It tells how much of the government's borrowings are going towards meeting expenses other than interest payments. Primary deficit thus gives an estimate of borrowings on account of current expenditure exceeding current revenues. The goal of measuring primary deficit is to focus on present fiscal imbalances.

Primary deficit = Fiscal deficit - Net Interest liabilities

Net interest liabilities interest payments minus interest receipts by the government on domestic lending.

Finance Bill

The Bill **produced immediately after the presentation of the union budget** detailing the **Imposition, abolition, alteration or regulation of taxes** proposed in the budget.

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Outcome budget

The outcome budget establishes a direct link between budgetary allocations of schemes and its annual performance targets measured through output and outcome indicators. The outcome budget is a progress card on what various ministries and departments have done with the outlays in the previous annual budget. It measures the development outcomes of all government programs and whether the money has been spent for the purpose it was sanctioned including the outcome of the fund usage.

Guillotine

The parliament has very limited time for examining the expenditure demands of all the ministries. So, once the prescribed period for the discussion on demands for grants is over, the speaker of Lok Sabha puts all the outstanding demands for grants, whether discussed or not, to the vote of the house. This process is popularly known as 'Guillotine'.

Cut Motions

Motions for reduction to various demands for grants are made in the form of cut motions seeking to reduce the sums sought by government on grounds of economy or difference of opinion on matters of policy or just in order to voice a grievance.

Consolidated Fund of India

All revenues received, loans raised and all moneys received by the government in repayment of loans are credited to the Consolidated Fund of India and all expenditures of the government are incurred from this fund. Money can be spent through this fund only if appropriated by the parliament. The consolidated Fund has further been divided into 'revenue' and 'capital' divisions.

Contingency Fund of India

A fund placed at the disposal of the President to enable him/her to make advances to the executive/Government to meet urgent unforeseen expenditure. Contingency fund enables the government to meet unforeseen expenditure and does not require prior legislative approval, unlike with the Consolidated Fund. For meeting such exigencies, advances are made to the executive from the contingency fund which is subsequently reported to the Parliament for recoupment from the Consolidated Fund of India.

Public Account

Under provisions of Article 266(1) of the Constitution of India, public account is used in relation to all the fund flows where government is acting as a banker. Examples include Provident Funds and Small Savings. This money does not belong to government but is to be returned to the depositors. The expenditure from this fund need not be approved by the parliament.

Notes

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I) Basics

Meaning

Fiscal policy involves use of government
- spending,
- taxation and
- borrowing

to influence both-
- pattern of economic activity and
- level of growth of agg. demand, output and employment

Objectives

The most common objectives of fiscal policy are:
- Achievement and maintenance of full employment
- Maintenance of price stability,
- Acceleration of rate of economic development
- Equitable distribution of income and wealth

The importance as well as order of priority of these objectives may vary from country to country and from time to time. For instance-
- stability and equality may be the priorities of developed nations,
- economic growth, employment and equity may get higher priority in developing countries

II) Types of Fiscal Policy

Expansionary fiscal policy

It is designed to stimulate the economy during contractionary phase.
- increasing aggregate expenditures, and
- decrease in taxes

Thereby increasing aggregate demand in future
It leads to larger government budget deficit or smaller budget surplus.

EFP is resorted to close the contractionary gap.

During deflation or during a period of sluggish economic activity when the rate of utilization of resources is less, EFP aims to compensate the deficiency in effective demand by boosting aggregate spending.

Contractionary fiscal policy

It is designed to stimulate the economy during inflationary phase.
- decreasing aggregate expenditures, and
- increase in taxes

Thereby decreasing aggregate demand in future.
It leads to smaller government budget deficit or larger budget surplus.

CFP is resorted to close the inflationary gap

If the state of the economy is such that its growth rate is extraordinarily high causing inflation and asset bubbles, contractionary fiscal policy can be used to confine it into sustainable levels.

III) Instruments of Fiscal Policy

III)a) Govt expenditure | III)b) Taxes | III)c) Public Debt | III)d) Govt Budget

III)a) Government (Public) expenditure

Fiscal policy relates to decisions that determine whether the govt's expenditure is more or less than what it receives.

A reduction or increase in it may result in significant variations in the country's total income.

As such, public expenditure can be instrumental in adjusting consumption and investment to achieve full employment.

Public expenditures are income-generating and include-
- Current expenditures to meet the day-to-day running of government
- Capital expenditures - investments made by the Government in capital equipments and infrastructure, and
- Transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers

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During Recession
It may initiate fresh wave of public works, such as construction of roads, irrigation facilities, ports, electrification of new areas etc.

During Inflation
To reduce severity of inflation and to bring down prices

Govt reduces expenditure -> Reduced incomes -> eliminate excess aggregate demand.

From where will govt find resources to increase its expenditure, during recession?

- If govt increases taxes→ it will be self-defeating as increased taxes will reduce the disposable incomes and thus aggregate demand.
- The govt should in such cases go for a deficit budget which may be financed either
  - ✓ through borrowing or
  - ✓ through monetization (creation of additional money to finance expenditure).

  The former runs the risk of crowding out private spending.
- Programme of public investment
- Primary employment in public works will induce employment, and the economy will be put on an expansion track.

III)b) Taxes

- Taxation policies are used for establishing stability in an economy.
- Tax as an instrument of fiscal policy consists of changes in-
  - ✓ government revenues or
  - ✓ in rates of taxes

aimed at encouraging or restricting private expenditures on consumption and investment.

- Taxes determine size of disposable income → which determines aggregate demand → & possible inflationary & deflationary gaps.

❑ During **recession & depression**,
- ✓ Taxes are reduced→ to encourage private consumption and investment.

❑ During **inflation**,
- ✓ New taxes can be levied & rates of existing taxes are raised → to reduce disposable incomes and to wipe off the surplus purchasing power.
- ✓ However, excessive taxation prevents new investments and thus govt has to be cautious about it

- The extent of tax reduction and /or increase in government spending required depends on the size of the recessionary gap and the magnitude of the multiplier.

III)c) Public Debt

Public debt may be;

- **Internal Debt**
  When government borrows from its own people in country, it is internal debt.
- **External Debt**
  When government borrows from outside sources, the debt is external debt.

Market Loans
Government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets.
- For financing capital projects -> long-term capital bonds are issued
- For meeting short-term government expenditure -> treasury bills are issued.

Small Savings
They represent public borrowings, which are not negotiable and are not bought and sold in the market.

Eg- Schemes introduced for mobilizing small savings such as National Savings Certificates, National Development Certificates, etc.

Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy.

Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

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III)c) Government Budget

The budget is simply a **statement** of **revenues earned** from taxes and other sources and **expenditures made** by a nation's government in a year.

The **net effect** of a budget on aggregate demand **depends on** the government's budget **balance.**

- **Balanced budget: (Revenue = Exp)**
  No net effect on aggregate demand since leakages (taxes) = injections (exp)
- **Budget surplus: (Revenues > Exp)**
  It has **negative net effect** on aggregate demand since leakages > injections
  It **reduces national debt**
- **Budget deficit: (Revenues < Exp)**
  It has **positive net effect** on aggregate demand since injections > leakages
  It **adds to the national debt**

IV) Fiscal policy for long-run economic growth

Demand-side policies unaccompanied by policies to stimulate aggregate supply cannot produce long-run economic growth.

Fiscal policy influence economic growth through its effects on the incentives faced by individuals and firms.
For example- (See next box)

- Fiscal policies such as those involving **infrastructure spending** generally have **positive supply-side effects.** When government supports building a modern infrastructure, the private sector is provided with the requisite overheads it needs.
- Government provision of **public goods** such as education, healthcare, etc. provide momentum for long-run economic growth through **human capital formation.** Increase in human capital **makes physical capital more productive.**
- **Taxes** can have either **positive** or **negative** impact on economic growth depending on whether it encourages or discourages saving and investment.
- A **well designed tax policy** that **rewards innovation** and entrepreneurship, without discouraging incentives will **promote private businesses** who wish to invest and thereby help the **economy grow.** For example, an increase in corporate taxes to raise extra revenue may have adverse consequences on incentives and output.
- **Tax and spending policies** (e.g. subsidies) can be **effectively used** to correct market failures resulting from externalities.
- **Increase in environment taxes** increase the cost of firms and **reduce their output**
- **Subsidies** on inputs and **support prices** to producers (e.g. farmers) generate **higher output.**

V) Fiscal policy for reduction in inequalities of income and wealth

Distribution of income is influenced by fiscal policy-
Directly- **Current disposable incomes** of are dependent on direct taxes,

- **Indirectly-** **Potential for future earnings** is indirectly influenced

Few measures as to how **govt exp & taxes can be manipulated** to achieve **desired redistribution of income..**

- **Progressive direct tax** system
- **Indirect taxes** can be **differential**

More tax on Luxury goods, Less tax on Necessities

A **carefully planned policy of public expenditure** helps in **redistributing income** from the rich to the poorer sections of the society. **Spending programmes** targeted on welfare measures for the disadvantaged

- **Poverty alleviation** programmes
- Free or subsidized **medical care, education**
- **Infrastructure** provision on a **selective basis**
- **Subsidized production** of products of **mass** consumption
- Public production and/ or grant of **subsidies** to ensure sufficient supply of essential goods, and
- **Strengthening human capital** for enhancing employability etc

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VI) Limitations of fiscal policy

1) Bad Timing- It is possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.

2) Difficulties in instantaneously changing governments' spending and taxation policies

3) Practically difficult to reduce government spending on various items such as defence and social security as well as on huge capital projects which are already midway.

4) Public works cannot be adjusted easily because many huge projects such as highways and dams have long gestation period.

5) Certain fiscal measures cause disincentives. For eg, increase in profits tax may adversely affect the incentives of firms to invest and an increase in social security benefits may adversely affect incentives to work and save.

6) Deficit financing increases the purchasing power of people. The production of G/S, in under-developed countries may not catch up simultaneously, resulting in prices spiraling beyond control.

7) Increase is government borrowing creates perpetual burden on even future generations as debts have to be repaid.

8) Crowding Out

During recession, government may resort to expansionary fiscal policy by increasing govt exp.

However, if taxes (revenue of govt) are not sufficient for the increased spending, then government increases its spending by borrowing from the loanable funds from the market the demand for loans increases and this pushes the interest rates up.

Similarly, when government increases the budget deficit by selling bonds or treasury bills, the amount of money with the private sector decreases and consequently interest rates will be pushed up.

As a result, private investments, especially the ones which are interest- sensitive, will be reduced.

Fiscal policy becomes ineffective as the decline in private spending partially or completely offsets the expansion in demand resulting from an increase in government expenditure.

Thus, an increase in the size of government spending during recessions will 'crowd-out' private spending in an economy and

- lead to reduction in an economy's ability to self-correct from the recession, and
- possibly reduce economy's prospects of long-run economic growth.

9) Lags

i. **Recognition Lag**
Lag in recognizing need for a policy change

ii. **Decision Lag**
Delays in deciding on most appropriate policy.

iii. **Implementation Lag**
Delays in bringing in legislation and implementing them

iv. **Impact Lag**
Outcomes of a policy are not visible for some time

Notes:

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CA Foundation - New Syllabus

Business Economics - Paper 4

SUPER CHART BOOK by MVSIR

Chapter 8
MONEY MARKET

(Weightage: 10 Marks)

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CHAPTER 8 - MONEY MARKET | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

Basics

- Money is something that holds its value over time, can be easily translated into prices, and is widely accepted.
- Fiat Money- Fiat money (aka. token money) has no intrinsic value (materially worthless), that is, it has no value if it were not used as money. It is used as medium of exchange as govt has, by law, made them "legal tender," which means, they serve, by law, as means of payment.

Definition of Money

Money can be defined for policy purposes as the set of liquid financial assets, the variation in the stock of which could impact on aggregate economic activity.

As a statistical concept, money could include certain liquid liabilities of a particular set of financial intermediaries or other issuers'.

Characteristics of Money

Money should be:
- generally acceptable
- durable or long-lasting
- effortlessly recognizable.
- difficult to counterfeit i.e. not easily reproducible by people
- relatively scarce, but has elasticity of supply
- portable or easily transported
- possessing uniformity; and
- divisible into smaller parts in usable quantities or fractions without losing value

Functions of Money

1) Convenient medium of exchange
2) Explicitly defined unit of value or unit of account
3) Serves as a unit or standard of deferred payment
4) Store of value

Demand for money

- If people desire to hold money, we say there is demand for money.
- Demand for money is in the nature of derived demand; it is demanded for its purchasing power.
- The demand for money is
  - ✓ Demand for real balances or liquidity (wish to have command over real goods and services - for day to day expenses)
  - ✓ Demand to store value (for future contingencies/requirements)
- Demand for money has an important role in the determination of
  - ✓ interest, (Int rate rises, opportunity cost of holding money rise, money demand falls)
  - ✓ prices and (Price level rises, money demand rises for transactions)
  - ✓ income. (Higher income, higher expenditure; richer people hold more money)
- Innovations such as internet banking, application based transfers and automated teller machines reduce the need for holding liquid money.

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Theories of demand for money

I) Classical Approach: Quantity Theory of Money | II) Cambridge Approach | III) Keynesian Theory of Demand for Money | IV) Inventory Approach to Transaction Balances | V) Friedman's Restatement of Quantity Theory | VI) Demand for Money as Behaviour toward Risk

I) Classical Approach: Quantity Theory of Money

- Given by Irving Fisher in his book 'The Purchasing Power of Money' published in 1911.
- As per QTM, money in circulation (M) & price level (P) are directly related to each other. (Linear) That is, changes in general level of commodity prices or changes in the value or purchasing power of money are determined first and foremost by changes in the quantity of money in circulation.
- QTM is aka. 'equation of exchange' or 'transaction approach'

$$MV = PT$$

Where, M = total amount of money in circulation in economy
V = transactions velocity of circulation i.e. no. of times money changes hand
P = average price level (P= MV/T) ; PT = Total demand of money
T = the total number of transactions ; MV = Total supply of money

- Later, Fisher extended the equation of exchange to include demand (bank) deposits (M') and their velocity (V')

$$\text{Expanded Form : } MV + M'V' = PT$$

Where, M' = the total quantity of credit money
V'= velocity of circulation of credit money

- Assuming full employment prevails - T, V, V' remains constant
- As per QTM, people would hold money in a quantity proportional to total transactions irrespective of interest rate [More Transactions -> More Demand of Money]

II) Cambridge Approach

- Aka Cash Balance Approach or Neo-Classical Theory
- Money increases utility in the following two ways-
  1) Split-up of sale and purchase to two different points of time (represents transaction motive)
  2) hedge against uncertainty. (money- a temporary store of wealth)
- Since sale & purchase do not take place simultaneously, people need 'temporary abode' of purchasing power as hedge against uncertainty.
- **How much money will be demanded as per Cambridge Approach?**

It depends partly on income and partly on wealth and interest rates.
-> Higher the income -> greater the transactions -> greater demand for money. Demand for money was determined by need to conduct transactions which will have a positive relationship to value of aggregate expenditure.

$$Md = k\,PY$$

Where, Md = is the demand for money balances,
Y = real national income,
P = average price level of currently produced goods and services
PY = nominal income ,
k = Cambridge k = proportion of nominal income (PY) that people want to hold as cash

- Above equation explains that demand for money (Md) equals k proportion of the total money income.

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III) Keynesian Theory of Demand for Money

According to Keynes' Liquidity Preference Theory', people hold money (M) in cash for three motives:
Transactions motive, Precautionary motive, & Speculative motive

a) Transactions motive

The need for cash for current transactions for personal and business exchange (income motive & business motive).
Money is demanded to bridge the time gap between receipt of income and planned expenditures.
Transaction demand for money is directly related to level of income

$$Lr = kY$$

Where, Lr, is the transactions demand for money,
k is the ratio of earnings which is kept for transactions purposes
Y is the earnings.

b) Precautionary motive

Individuals & businesses keep a portion of their income to finance unanticipated expenditures which may occur due to unforeseen and unpredictable contingencies.

Keynes regarded the precautionary balances as income elastic and not very sensitive to rate of interest (interest inelastic)

c) Speculative motive

People demand to hold money balances to take advantage of the future changes in the rate of interest, which is the same as future changes in bond prices. (to exploit any attractive investment opportunity)

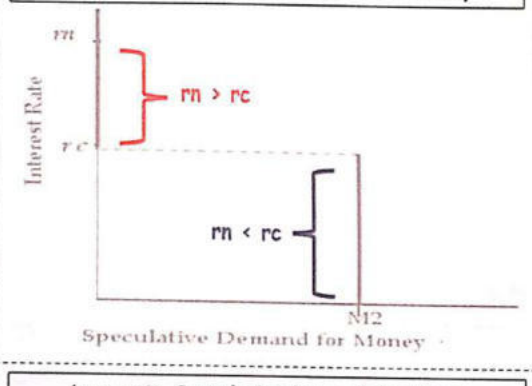
Keynes assumed that expected return on money is zero, while expected returns on bonds are of two types, namely: interest payment & expected rate of capital gain

Market Value of Bond inversely related to Market Rate of Interest

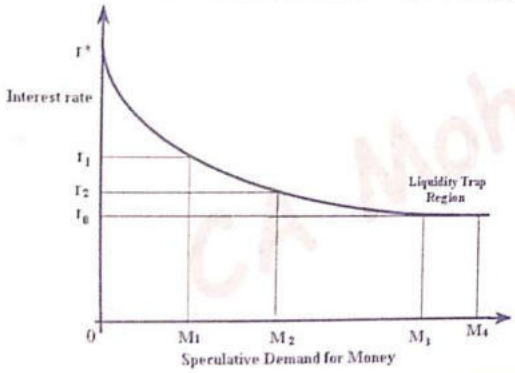
Current rate of interest (rn) > Critical rate of interest (rc)	Current rate of interest (rn) < Critical rate of interest (rc)
People expect a fall in interest rate (rise in bond prices)	People expect a rise in interest rate (fall in bond prices)
People will convert their cash balances into bonds- ➢ To earn high rate of return on bonds, or ➢ they expect capital gains resulting from a rise in future bond prices	People would hold their wealth in the form of liquid cash rather than bonds because- › loss suffered by way of interest income forgone is small › can avoid the capital losses › return on money balances will be greater than the return on alternative assets › If interest rate does increase in future, bond prices will fall & idle cash balances held can be used to buy bonds at lower price and can thereby make a capital-gain in future

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Individual's Speculative Demand for Money



Aggregate Speculative Demand for Money



Liquidity Trap

- When interest rates fall to very low levels, the expectation is that since the interest rate is very low it cannot go further lower and that in all possibility it will move upwards.
- When interest rates rise, the bond prices will fall (interest rates and bond prices are inversely related).
- To hold bonds at this low interest rate is to take almost certain risk of a capital loss (as the interest rate rises and bond prices fall).
- Thus,
  - ☐ desire to hold bonds is very low and approaches zero, and
  - ☐ demand to hold money in liquid form approaches infinity.
- The speculative demand becomes perfectly elastic with respect to interest rate and the speculative money demand curve becomes parallel to the X axis.
- This situation is called a 'Liquidity trap'. In such a situation, the monetary authority is unable to stimulate the economy with monetary policy.
- Since the opportunity cost of holding money is zero, even if the monetary authority increases money supply to stimulate the economy, people would prefer to hoard money. Consequently, excess funds may not be converted into new investment.
- The liquidity trap is synonymous with ineffective monetary policy.

Post-Keynesian developments in Theory of Demand for Money

- IV) Inventory Approach to Transaction Balances
- V) Friedman's Restatement of Quantity Theory
- VI) Demand for Money as Behaviour toward Risk

Notes:

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IV) Inventory Approach to Transaction Balances

- Given by **Baumol and Tobin** (theory is aka Inventory Theoretic Approach), in which money or 'real cash balance' was essentially viewed as an inventory held for transaction purposes.
- Inventory models assume that there are two media for storing value:
  1) Money &
  2) an interest-bearing alternative financial asset
- There is fixed cost of making transfers between money & alternative assets e.g. brokerage
- As per Baumol, people hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes opportunity cost.
- The level of inventory holding (holding money in cash)-

is **DIRECTLY RELATED** to
- Income of person
- Cost of making transfer between money and bonds

& is **INDIRECTLY RELATED** to
- Carrying cost - (interest income foregone by holding money)
- Number of times bond transaction are made

V) Friedman's Restatement of Quantity Theory

Milton Friedman (1956) extended Keynes' speculative money demand within the framework of asset price theory. Demand for money is affected by-
- Permanent income (present expected value of all future income)
- Relative returns on assets. (which incorporate risk)

Friedman's **four determinants** of the demand for money
1) Total wealth = Permanent Income / discount rate

Where, discount rate is average return on five asset classes in money, bonds, equity, physical capital and human capital.

2) Positively related to the Price Level, P

3) Rises if opportunity costs of money holdings (i.e. returns on bonds and stock) decline

4) Inflation - Positive inflation rate reduces the real value of money balances, thereby increasing the opportunity costs of money holdings

VI) Demand for Money as Behaviour toward Risk

Given by **Tobin** in his article, 'Liquidity Preference as Behaviour towards Risk' (1958)

According to Tobin, an individual would hold an optimally structured wealth portfolio which is comprised of both
- Bonds- (provides return for the risk borne) and
- Money- (No return, but also no risk)

The rational behaviour of a risk-averse economic agent induces him to hold an optimally structured wealth portfolio which is comprised of both bonds and money.

The overall expected return on portfolio would be higher if portfolio were all bonds, but an investor who is 'risk-averse' will be willing to exercise a trade- off and sacrifice to some extent the higher return for a reduction in risk.

Just as Keynes' theory, Tobin's theory implies that the demand for money as a store of wealth depends negatively on the interest rate.

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Basics

- The term money supply denotes the total quantity of money available with public
- Two things about any measure of money supply:

The supply of money is a stock variable i.e. it refers to the total amount of money at any particular point of time.

It is the change in the stock of money (say, increase or decrease per month or year), which is a flow.

The stock of money always refers to the stock of money available to the 'public' as a means of payments and store of value.

This is always smaller than the total stock of money that really exists in an economy.

- 'Public' is defined to include all economic units (households, firms and institutions) except the producers of money (i.e. the government and the banking system).
- Government = Central Government and all State governments and local bodies.
- Banking system means RBI and all banks that accept demand deposits (i.e. deposits from which money can be withdrawn by cheque mainly CASA deposits).
- Thus, 'supply of money' EXCLUDES
  - ❑ interbank deposits and
  - ❑ money held by government and
  - ❑ money held by banking system

Rationale of measuring money supply

Empirical analysis of money supply is important because-

1) Facilitates analysis of monetary developments to provide an understanding of causes of money growth.

2) Provides a framework to evaluate whether stock of money in economy is consistent with- standards for price stability and to understand the nature of deviations from this standard. It helps central banks in making monetary policy

Sources of money supply

Central Banks → **High powered money or Monetary Base**

It is issued by monetary authorities, which is the source of all other forms of money.

The currency issued by the central bank is 'fiat money' and is backed by supporting reserves and its value is guaranteed by the government.

Banking system → **Credit Money**

Banks create money supply in the process of borrowing and lending transactions with the public.

High powered money + Credit Money = Total money stock of a country

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- The concept of money has experienced evolution from Commodity to Metallic Currency to Paper Currency to Digital Currency.
- Advancement in technology has made it possible for the development of new form of money viz. Central Bank Digital Currencies (CBDCs).
- RBI has also been exploring the pros and cons of introduction of CBDCs & is currently engaged in working towards a phased implementation strategy, for the issuance of its own CBDC [Digital Rupee (e₹)], with minimal or no disruption to the financial system.
- Reserve Bank broadly defines "CBDC" as the legal tender issued by a central bank in a digital form. It is akin to sovereign paper currency but takes a different form, exchangeable at par with existing currency and shall be accepted as a medium of payment, legal tender and a safe store of value. CBDCs would appear as liability on a central bank's balance sheet.
- Also, Crypto currencies face significant legislative uncertainties and are not legally recognized in India as currency. Hence, these are not categorized as money. In 2018, RBI had barred banks or other financial entities from dealing with virtual cryptocurrencies.

Measurement of money supply

Since July 1935, RBI has been compiling & disseminating monetary statistics. Till 1967-68, RBI published a single 'narrow measure of money supply' → Old M1 = Currency (+) demand deposits held by the public.

From 1967-68, a 'broader' measure of money supply, called '**aggregate monetary resources**' (AMR) was additionally published by RBI.

From April 1977, following the recommendations of the Second Working Group on Money Supply (SWG), RBI has been publishing data on four alternative measures of money supply denoted by M1, M2, M3 and M4 besides reserve money (M0).

Reserve money is also known as- central bank money, base money or, high-powered money

Reserve money determines -
> level of liquidity and
> price level in economy and,
thus, its management is of crucial importance to stabilize the economy.

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

	Currency with Public
+	Demand deposits with banks (Current A/c & Saving A/c)
+	Other deposits with RBI
	M1 (Narrow Money)

	M1
+	Savings dep with Post Office
	M2

	M1
+	Time deposits with Banks
	M3 (Broad Money)

	M3
+	Total dep. with Post Office (excl. National Savings Cert.)
	M4

	Notes in Circulation
+	Circulation of Rupee Coin
+	Circulation of Small Coins
-	Cash on Hand with Banks
	Currency with Public

- Descending order of liquidity - M1 (Most Liquid) & M4 (Least Liquid)
- 'Other deposits' with the RBI excludes those held by the government (Central & State Govt.)

Difference M0 & M1	M0	M1
Bank Reserves	✓	✗
Bank Deposits	✗	✓

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There are 2 alternate theories in respect of determination of money supply.

1) First view, money supply is determined exogenously by the central bank.
2) The second view, holds that the money supply is determined endogenously by changes in the economic activities

The current practice is to explain the determinants of money supply based on 'money multiplier approach'.

Money Multiplier (m)

The money multiplier process explains how an increase in the monetary base causes the money supply to increase by a multiplied amount. It is the ratio of stock of money to stock of high-powered money

1st Formula

$$\text{Money Multiplier (m)} = \frac{\text{Money supply (M)}}{\text{Monetary Base (MB)}}$$

where, Monetary Base = Currency in circulation + Bank reserves

2nd Formula

$$\text{Money Multiplier (m)} = \frac{1 + c}{r + e + c}$$

where,
c = currency ratio = currency / deposits
r = required reserve ratio = required reserves / deposits
e = excess reserve ratio = excess reserves / deposits

3rd Formula

If we assume-
1) Banks never hold excess reserves. (e = 0)
2) Individuals and non-bank corporations never hold currency (c = 0)

Then, money multiplier is reciprocal of the required reserve ratio.

Money Multiplier (m) = 1 / Required Reserve Ratio
= 1 / R

m = 1 / R
formula can also be referred to as the **Credit Multiplier or Deposit Multiplier or Deposit Expansion Multiplier**

It describes amount of additional money created by commercial bank through process of lending the available money it has in excess of central bank's reserve requirements.

Determinants of Money Supply

Money multiplier approach to money supply propounded by Milton Friedman and Anna Schwartz, (1963) considers three factors as immediate determinants of money supply-

1) **Stock of high-powered money (H)**
Depends upon Behaviour of Central Bank

2) **Reserve-ratio (r) = R / D**
Depends upon Behaviour of Commercial Banks

3) **Currency Deposit Ratio (c) = C / D**
Depends upon Behaviour of Public

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1) Stock of high-powered money (H)
Depends upon Behaviour of Central Bank

Money stock is determined by the money multiplier and the monetary base (H) is controlled by the monetary authority. Other factors being constant, total supply of money in economy varies directly with the supply of high-powered money.

2) Reserve-ratio (r) = R / D
Depends upon Behaviour of Commercial Bank

If required reserve ratio increases -
- banks will decrease lending,
- causing a decline in deposits

and hence money supply will decline.

If required reserve ratio decreases -
- banks will increase lending,
- causing a rise in deposits

and hence money supply will increase.

Smaller the required reserve ratio -> larger will be the money multiplie

Excess Reserves

Excess Reserves (ER) are funds that a bank keeps as reserve beyond what is required by regulation as a buffer against unexpected events requiring cash.

Excess reserves (ER) = Total reserve (TR) - Reqd. Reserve (RR)

Excess Reserves of commercial banks do not lead to any additional loans, and thus, do not lead to creation of money

Smaller the excess reserve ratio -> larger will be the money multiplier

Cost of holding excess reserves = opportunity cost, i.e. the interest that could have been earned on loans

When costs to bank of holding ER (market rate of interest) rises , level of ER falls -> m will be larger

If banks fear that deposit outflows are likely to increase (that is, if expected deposit outflows increase), banks will want more assurance against this possibility and will increase ER ratio. Thereby m will fall

Eg- During festival season, people decide to use ATMs very often

3) Currency Deposit Ratio (c) = C / D
Depends upon Behaviour of Public

Demand deposits undergo multiple expansions while currency in your hands does not.

If public decides to keep more money in their pocket and less money in bank. It leads to an increase in currency ratio and banks can create only less credit money. Thus m falls.

Eg- Fearing shortage of money in ATMs, people decide to hoard money

Currency-deposit ratio (c) also represents degree of adoption of banking habits by people. It is affected by the degree of financial sophistication in terms of ease and access to financial services, financial innovations, etc.

Eg- 1) Banks open large number ATMs all over the country, or
2) E-banking becomes very common and nearly all people use them

ATMs let people to withdraw cash from bank as & when needed, reduces cost of conversion of deposits to cash & makes deposits relatively more convenient. People hold less cash & more deposits, thus reducing currency-deposit ratio; increasing money multiplier & money supply

The time deposit-demand deposit ratio (TD/DD ratio) i.e. how much money is kept as time deposits compared to demand deposits.

An increase in TD/DD ratio means that greater availability of free reserves which leads to increase in volume of multiple deposit expansion & thus, high multiplier

Can m = 0 ? It may happen when- interest rates are too low & banks prefer to hold deposits as excess reserves with no risk attached to it.

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CHAPTER 8 - MONEY MARKET | UNIT 2 - THE CONCEPT OF MONEY SUPPLY

Monetary Policy and Money Supply

If the central bank of a country wants to stimulate economic activity it does so by infusing liquidity into the system.

Eg - Open Market Operations (OMO) by central banks.

- ❑ Purchase of government securities injects high powered money (monetary base) into the system.

Assuming that

- ➢ banks do not hold excess reserves and
- ➢ people do not hold more currency than before &
- ➢ also that there is demand for loans from businesses,

credit creation process by banking system will create money to the tune of

$$\Delta \text{ Money Supply} = \frac{1}{R} \times \Delta \text{ Reserves}$$

Effect of government expenditure on money supply

Whenever central and state governments' cash balances fall short of the minimum requirement, they are eligible to avail of a facility called Ways and Means Advances (WMA)/overdraft (OD) facility.

When RBI lends to governments under WMA /OD, it results in the generation of excess reserves (i.e., excess balances of commercial banks with the Reserve Bank).

This happens because when government incurs expenditure, it involves debiting the government balances with the Reserve Bank and crediting the receiver (for e.g., salary account of government employee) account with the commercial bank.

The extra reserves thus created can potentially lead to an increase in money supply through the money multiplier process.

CHAPTER 8 - MONEY MARKET | UNIT 3 - MONETARY POLICY

Monetary Policy Defined

- ➢ RBI uses monetary policy to manage economic fluctuations & achieve price stability, which means that inflation is low and stable.
- ➢ RBI conducts monetary policy by adjusting supply of money, usually through buying or selling securities in open market.
- ➢ Open market operations affect short-term interest rates, which in turn influence longer-term rates & economic activity.
- ✓ When RBI lower interest rates, monetary policy is easing.
- ✓ When it raises interest rates, monetary policy is tightening

The Monetary Policy Framework

The central bank, in its execution of monetary policy, functions within an articulated monetary policy framework which has three basic components, viz.

(i) objectives of monetary policy,

(ii) analytics of monetary policy which focus on transmission mechanisms, &

(iii) operating procedure which focuses on operating targets & instruments

Objectives of monetary policy

RBI Act, 1934, in its preamble sets out the objectives of the Bank as 'to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

The primary objective of monetary policy is maintenance of judicious balance between price stability & economic growth.

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Objectives of Monetary Policy in case of developing countries

1) maintenance of economic growth
2) ensuring an adequate flow of credit to productive sectors
3) sustaining a moderate structure of interest rates to encourage investments,
4) creation of an efficient market for government securities.

Transmission of Monetary Policy

The transmission of the monetary policy describes how changes made by RBI to its monetary policy settings flow through to economic activity and inflation.
In simple terms, the transmission can be summarised in two stages.
1. Changes to monetary policy affect interest rates in the economy.
2. Changes to interest rates affect economic activity and inflation

Channels of Monetary Policy Transmission

1) Saving and Investment Channel

This channel typically affects consumption, housing investment, and business investment.

- **Lower interest rates on bank deposits** reduce incentives of households to save their money. Instead, there is an increased incentive for them to spend their money on G/S.
- **Lower interest rates for loans** can encourage households to borrow more as they face lower repayments. Lower lending rates support higher demand for assets, such as housing
- **Lower lending rates** can increase investment spending by businesses (on capital goods like new equipment or buildings). This is because the cost of borrowing is lower, and because of increased demand for the goods and services they supply. This means that returns on these projects are now more likely to be higher than the cost of borrowing, helping to justify going ahead with the projects.

2) Cash-flow Channel

Monetary policy influences interest rates, which affects the decisions of households and businesses by changing the amount of cash they have available to spend on goods and services.

- A reduction in lending rates **reduces interest repayments on debt**, increasing the amount of cash available for households and businesses to spend on G/S.
- At the same time, a reduction in interest rates **reduces the amount of income** that households and businesses get from deposits, and some may choose to restrict their spending

These two effects work in opposite directions, but a reduction in interest rates can be expected to increase spending in economy
(with the first effect larger than the second)

3) Asset Prices and Wealth Channel

Asset prices and people's wealth influence how much they can borrow & spend. This channel affects consumption & investment.

- **Lower interest rates support asset prices** (such as housing & equities) by encouraging demand for assets. One reason for this is that the present discounted value of future income is higher when interest rates are lower.
- **Higher asset prices also increase the equity** (collateral) of an asset that is available for banks to lend against. This can make it easier for households and businesses to borrow.
- **An increase in asset prices increases people's wealth**. This can lead to higher consumption and housing investment as households generally spend some share of any increase in their wealth

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4) Exchange Rate Channel

The exchange rate can influence sectors that are export-oriented or exposed to competition from imported goods and services.

- If **RBI lowers cash rate** it means that interest rates have fallen in India compared with interest rates in rest of world (all else being equal).
- **Lower interest rates reduce returns investors earn from assets in India** (relative to other countries). Lower returns reduce demand for assets in India (also for Indian rupees) with investors shifting their funds to foreign assets (and currencies) instead.
- A reduction in interest rates (compared with rest of world) results in a **lower exchange rate**, making foreign goods and services more expensive compared with those produced in India. This leads to an increase in exports and domestic activity.
- A lower exchange rate also adds to inflation, as imports become more expensive in Indian rupees.

Operating Procedures and Instruments

Quantitative tools

The tools applied by the policy that impact money supply in the entire economy, including sectors such as manufacturing, agriculture, automobile, housing, etc

1.	Reserve Ratio	Banks are required to keep aside a set percentage of cash reserves or RBI approved assets. Reserve ratio is of two types
1a.	Cash Reserve Ratio (CRR)	Banks are required to set aside this portion in cash with the RBI. The bank can neither lend it to anyone nor can it earn any interest rate or profit on CRR
1b.	Statutory Liquidity Ratio (SLR)	Banks are required to set aside this portion in liquid assets such as gold or RBI approved securities such as government securities. Banks are allowed to earn interest on these securities, however it is very low.
2.	Open Market Operations (OMO)	In order to control money supply, the RBI buys and sells government securities in the open market. These operations conducted by the Central Bank in the open market are referred to as Open Market Operations. When the RBI sells government securities, the liquidity is sucked from the market, and the exact opposite happens when RBI buys securities. The latter is done to control inflation. The objective of OMOs are to keep a check on temporary liquidity mismatches in the market, owing to foreign capital flow

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Qualitative tools

Unlike quantitative tools which have a direct effect on the entire economy's money supply, qualitative tools are selective tools that have an effect in the money supply of a specific sector of the economy

1.	Margin requirements	The RBI prescribes a certain margin against collateral, which in turn impacts the borrowing habit of customers. When the margin requirements are raised by the RBI, customers will be able to borrow less
2.	Moral suasion	By way of persuasion, the RBI convinces banks to keep money in government securities, rather than certain sectors.
3.	Selective credit control	Controlling credit by not lending to selective industries or speculative businesses.
4.	Market Stabilisation Scheme (MSS)	Under MSS the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities.

Policy Rates

Unlike quantitative tools which have a direct effect on the entire economy's money supply, qualitative tools are selective tools that have an effect in the money supply of a specific sector of the economy

1.	Bank Rate	The interest rate at which RBI lends long term funds to banks is referred to as the bank rate. Bank rate is used to prescribe penalty to the bank if it does not maintain the prescribed SLR or CRR However, presently RBI does not entirely control money supply via the bank rate. It uses Liquidity Adjustment Facility (LAF) - repo rate as one of the significant tools to establish control over money supply.
2.	Liquidity Adjustment Facility (LAF)	RBI uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are-
2a.	Repo Rate	Repo rate is the rate at which banks borrow from RBI on a short-term basis against a repurchase agreement. Under this policy, banks are required to provide government securities as collateral and later buy them back after a pre-defined time.
2b.	Reverse Repo Rate	It is the reverse of repo rate, i.e., this is the rate RBI pays to banks in order to keep additional funds in RBI. It is linked to repo rate in the following way: **Reverse Repo Rate = Repo Rate - 1**
3.	Marginal Standing Facility (MSF) Rate	MSF Rate is the penal rate at which the Central Bank lends money to banks, over the rate available under the rep policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities. **MSF Rate = Repo Rate + 1**

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People deposit money in bank-
- Demand Deposits- SA, CA
- Time Deposits- FD etc

Asset for depositors
Liabilities for Bank - NDTL



Rs 500 cr

4% of 500 cr = 20 Cr

20% of 500 cr = 100 cr

Balance Amt (76%) = 380 cr

Funds available with bank for giving loans (Loanable Funds)

CRR

Specified % of NDTL required to be maintained with RBI



SLR

Specified % of NDTL required to be maintained with Bank itself in form of
- Cash
- Gold
- un-encumbered Instruments

NDTL
Rs 500 cr



Required Reserves-
CRR: 4% = Rs 20 Cr
SLR: 20% = Rs 100 Cr

Actual Reserves-
CRR = Rs 20 Cr
SLR = Rs 150 Cr

Cash 80 Cr | Gold 20 Cr | Gov Sec. 50 Cr

↓

Excess Cash 50 Cr

Banks can deposit surplus funds available with them to RBI

↓

When RBI borrows money from commercial banks by
- selling them securities (which RBI permits) with an agreement to repurchase securities
- on a mutually agreed future date
- at an agreed price which includes interest for funds borrowed.

↓

Interest rate paid by RBI for borrowings from commercial banks is -"Reverse Repo Rate"

↓

RBI absorbs liquidity, on an overnight basis, from banks against collateral of eligible government securities under the LAF

NDTL
Rs 500 cr



Required Reserves-
CRR: 4% = Rs 20 Cr
SLR: 20% = Rs 100 Cr

Actual Reserves-
CRR = Rs 20 Cr
SLR = Rs 150 Cr

Cash 50 Cr | Gold 20 Cr | Gov Sec. 80 Cr

↓

Excess Gov Sec. 50 Cr

LAF is a facility extended to scheduled commercial banks and primary dealers to avail liquidity on an overnight basis against collateral of government securities

↓

When banks face liquidity crunch (short period)

↓

Banks can borrow funds from RBI (using LAF window) against collateral of government securities

↓

Step 1
Bank sells securities (excess available over SLR Req) & receive cash -> RBI buys securities & parts with cash.

Step 2
Securities are repurchased by original holder (bank). The bank pays to RBI amount originally received, plus return on money for the number of days for which money was used, which is mutually agreed.

The rate at which RBI lends money to banks as per above process is called Repo Rate

NDTL
Rs 500 cr



Required Reserves-
CRR: 4% = Rs 20 Cr
SLR: 20% = Rs 100 Cr

Actual Reserves-
CRR = Rs 20 Cr
SLR = Rs 100 Cr

Cash 50 Cr | Gold 20 Cr | Gov Sec. 30 Cr

↓

No Excess Gov Sec.

RBI, being bankers' bank, acts as a lender of last resort

MSF would be last resort for banks once they exhaust all borrowing options including LAF.

↓

MSF refers to the facility under which scheduled commercial banks can-
- borrow additional amount of overnight money from RBI
- over and above what is available to them through the LAF window
- by dipping into their SLR portfolio
- up to a limit
- at a penal rate of interest (MSF Rate)

↓

This provides a safety valve against unexpected liquidity shocks to the banking system.

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Organisational Structure For Monetary Policy Decisions

The Reserve Bank of India (RBI) Act, 1934 was amended in 2016, for giving a statutory backing to the Monetary Policy Framework Agreement.

It is an agreement reached between the Government of India and the RBI on the maximum tolerable inflation rate that the RBI should target to achieve price stability.

The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework'.

Announcement of an official target range for inflation is known as inflation targeting.

The Expert Committee under Urijit Patel revised the monetary policy framework, in January, 2014 & suggested to abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy.

The inflation target is to be set by the Government of India, in consultation with RBI, once in every five years.

Accordingly, Central Government has notified-

- 4 per cent Consumer Price Index (CPI) inflation as the target for period from Aug 5, 2016 to Mar 31, 2021 with the-
  - ✓ upper tolerance limit of 6 per cent and
  - ✓ lower tolerance limit of 2 per cent.

The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months

The following factors are notified by the central government as constituting a failure to achieve the inflation target

- Average inflation is more than upper tolerance level of inflation target for any three consecutive quarters; or
- Average inflation is less than lower tolerance level for any three consecutive quarters.

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Chapter 9

INTERNATIONAL TRADE

(Weightage: 10 Marks)

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CHAPTER 9 - INTERNATIONAL TRADE | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

Basics

International trade is exchange of G/S as well as resources between countries

It involves transactions-

- between residents of different countries
- involves transactions in multiple currencies
- greater complexity as it involves heterogeneity of customers and currencies differences in legal systems business practices more elaborate documentation etc

Benefits of International Trade

1) Powerful stimulus to economic efficiency & contributes to economic growth and rising incomes.
2) Efficient deployment of productive resources to their best use is a direct economic advantage of foreign trade. Greater efficiency in the use of resources ensures productivity gains. It also tends to decrease the likelihood of domestic monopolies, it is always beneficial to the community.
3) Trade provides access to new markets and new materials & enables sourcing of inputs internationally at competitive prices. This reflects in innovative products at lower prices and wider choice in products and services for consumers. It also enables nations to acquire foreign exchange reserves necessary for imports which are crucial for sustaining their economies.
4) International Trade necessitates increased use of automation, supports technological change, stimulates innovations, and facilitates greater investment in research and development and productivity improvement in the economy.
5) Trade also provides greater stimulus to innovative services in banking, insurance, logistics, consultancy services etc.
6) For emerging economies, improvement in the quality of output of G/S, superior products, finer labour etc. enhance value of products & enable them to move up the global value chain.
7) Opening up of new markets results in broadening the productive base and facilitates export diversification so that new production possibilities are opened up.
8) Trade can also contribute to human resource development, by facilitating fundamental and applied research and exchange of know-how and best practices between trade partners.
9) Strengthens bonds between nations & thus, promotes harmony & cooperation in nations.

Major arguments put forth against trade openness

1) Not equally beneficial to all nations. Potential unequal market access and disregard for principles of fair trading.
2) Economic exploitation→ growing political power of corporations operating globally. Domestic entities can be outperformed by financially stronger transnational cos.
3) Substantial environmental damage and exhaustion of natural resources.
4) Trade cycles and the associated economic crises occurring in a country get transmitted rapidly to other countries.
4) Risky dependence of underdeveloped countries on foreign nations, impairs economic autonomy & endangers their political sovereignty → exploitation & loss of cultural identity.
5) Too much export orientation may distort actual investments away.
6) There is often a lack of transparency and predictability related to trade policies of trading partners. There are also many risks in trade associated with changes in governments' policies of participating countries, such as imposition of an import ban, high import tariffs or trade embargoes.

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Theories of international trade

1) The Mercantilists' View of International Trade
2) The Theory of Absolute Advantage
3) The Theory of Comparative Advantage
4) The Heckscher-Ohlin Theory of Trade
5) New Trade Theory - An Introduction

The Mercantilists' View of International Trade

- Mercantilism, which is derived from the word mercantile, "trade and commercial affairs". Mercantilism according to Microsoft Encarta Dictionary (2009), was the economic policy in Europe from 16th to 18th centuries.
- Mercantilism advocated maximizing exports in order to bring in more "specie" (money in the form of precious metals rather than notes) and minimizing imports through the state imposing very high tariffs on foreign goods.
- This view argues that trade is a zero-sum game', with winners who win, does so only at the expense of losers and one country's gain is equal to another country's loss, so that the net change in wealth or benefits among the participants is zero.
- The arguments put forth by mercantilists were later proved to have many shortcomings by later economists

The Theory of Absolute Advantage

- According to Adam Smith, a country will specialize in production and export of commodity in which it has an absolute cost advantage
- The principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources.
- Adam Smith described principle of absolute advantage in the context of international trade, using labor as the only input.
- Exchange of goods between two countries will take place only if each of two countries can produce one commodity at an absolutely lower production cost than the other country

Commodity	Productivity of Labour Output per Hour of Labour	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	5

A has absolute advantage in production of wheat, so country A will export & specialize in production of wheat

B has absolute advantage in production of cloth so country B will export & specialize in production of cloth

The above theory explained that mutually gainful trade is possible.

Notes:

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The Theory of Comparative Advantage

This law given by By Ricardo states that even if one nation is less efficient than (has an absolute disadvantage with respect to) other nation in production of all commodities there is still scope for mutually beneficial trade

Commodity	Productivity of Labour (Output per Hour of Labour)	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	2

In above eg, A has absolute advantage in production of both wheat & cloth

- Wheat [6 : 1]
- Cloth [4 : 2]

However, A has greater absolute advantage (comparative advantage) in case of wheat Hence A should specialize in production & export of wheat

Further, B has lower absolute disadvantage (comparative advantage) in case of cloth. Hence B should specialize in production & export of cloth

Douglas Irwin (2009) calls comparative advantage "good news" for economic development. "Even if a developing country lacks an absolute advantage in any field, it will always have a comparative advantage in the production of some goods," and will trade profitably with advanced economies.

The Heckscher-Ohlin Theory of Trade

Aka. Factor-Endowment Theory of Trade or Modern Theory of Trade or Heckscher-Ohlin Samuelson theorem

This theory states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations

Factor endowment' refers to the overall availability of usable resources- labour & capital

It states that a country tends to-

- specialize in the export of a commodity whose production requires intensive use of its abundant resources and
- imports a commodity whose production requires intensive use of its scarce resources

- ❑ Capital abundant country- Produce and export capital-intensive goods relatively more cheaply than other countries.
- ❑ Labour-abundant country- Produce and export labour-intensive goods relatively more cheaply than another country.

Theory of Comparative Adv.	Modern Theory
Trade occurs due to difference between countries' comparative costs	Explains causes of differences in comparative costs as differences in factor endowments
Based on labour theory of value	Based on money cost - more realistic.
Considered labour as sole factor of production one factor (labour) model	Widened scope - labour and capital as factors of production. It is 2-factor model
Treats international trade as quite distinct from domestic trade	International trade is only a special case of inter-regional trade.
Studies only comparative costs of the goods concerned	Considers relative prices of factors which influence comparative costs
Diff in cost due to differences in productive efficiency of workers	Diff in cost due to differences in factor endowments.
Does not take into account the factor price differences	Considers factor price differences as the main cause price differences

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New Trade Theory

NTT helps in understanding why developed & big countries are trade partners when they are trading similar G/S. Eg- electronics, IT, cars etc

Those countries with the advantages will dominate the market and the market takes the form of monopolistic competition

Two key concepts give advantages to countries that import goods to compete with products from the home country

1) Economies of Scale- If firm serves domestic as well as foreign market then it can reap benefit of large scale of production & increase profits.

2) Network Effects- The value of G/S is enhanced as number of individuals using it increases. This is called bandwagon effect Consumers like more choices but they also want G/S with high utility and network effect increases utility Eg- What's App and software like Windows

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Basic Definitions

- **Free Trade-** Buyers and sellers from separate economies voluntarily trade with minimum of state interference.
- **Protectionism:** It is a state policy aimed to protect domestic producers against foreign competition through the use of tariffs, quotas and non-tariff trade policy instruments.
- **Trade liberalization:** It refers to opening up of domestic markets to G/S from rest of world by lowering trade barriers.
- **Trade policy:** It consists of all instruments that govts may use to promote or restrict imports & exports. Instruments of trade policy are-
  - price- related measures such as tariffs and
  - Non-price measures or non-tariff measures (NTMs).

Tariffs

- Tariffs, (aka) customs duties are basically taxes or duties imposed on G/S which are imported or exported.
- It is defined as a financial charge in the form of a tax imposed at the border on goods going from one country to another.
- They are the most visible and universally used trade measures that determine market access for goods.
- Instead of a single tariff rate, countries have a tariff schedule which specifies the tariff collected on every particular G/S.
- Tariffs are aimed at altering the relative prices of G/S imported, so as to contract domestic demand and thus regulate the volume of their imports
- Tariffs also raise revenue of government.

Types of Tariffs

1) **Specific Tariff**- It is fixed amount of money per physical unit or according to weight or measurement of commodity imported or exported. Eg- Specific tariff of Rs. 1000 may be charged on each imported bicycle irrespective of its value.
   Disadvantage- Its protective value varies inversely with the price of the import

2) **Ad Valorem Tariff**- When duty is levied as fixed percentage of value of traded commodity. A 20% ad valorem tariff on any bicycle.
   This tariff preserves protective value of tariff on home producer, but it gives incentives to deliberately undervalue good's price on invoices to reduce tax burden.

3) **Mixed Tariffs**- They are expressed either on basis of value of imported goods (an ad valorem rate) or on basis of a unit of measure of the imported goods (a specific duty) whichever is higher. For Eg, duty on cotton: 5 per cent ad valorem or Rs. 3000/per tonne, whichever is higher.

4) **Compound Tariff**- It is generally calculated by adding up a specific duty to an ad valorem duty. Thus, on an import with quantity q and price p, a compound tariff collects a revenue = $t_s q + t_a pq$,
   where t_s is the specific tariff and t_a is the ad valorem tariff
   For example: duty on cheese at 5 per cent ad-valorem plus 100 per kilogram.

5) **Technical/Other Tariff**- These are calculated on the basis of the specific contents of imported goods i.e. duties are payable by its components or related items. For Eg- Rs. 3000 on each solar panel plus Rs. 50/per kg on battery.

6) **Tarrif Rate Quota-** TRQs combine two policy instruments quotas and tariffs Imports entering under specified quota portion are subject to lower or zero tariff rate. Imports above quantitative threshold of quota face a much higher tariff

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7) Most-Favoured Nation Tariffs- Import tariffs which countries promise to impose on imports from other members of WTO, unless country is part of a preferential trade agreement (such as a free trade area or customs union). In practice, MFN rates are the highest that WTO members charge each other. Some countries impose higher tariffs on countries that are not part of the WTO.

8) Variable Tariff- A duty typically fixed to bring the price of an imported commodity up to level of the domestic support price for the commodity.

9) Preferential Tariff- Countries promise to give another country's products lower tariffs than their MFN rate. These agreements are reciprocal. Examples are preferential duties in the EU region under which a good coming from one EU country to another is charged zero tariff rate. Countries, may also grant 'unilateral preferential treatment' Eg- Generalized System of Preferences (GSP)

10) Bound Tariff- A WTO member binds itself with legal commitment not to raise tariff rate above a certain level (maximum level of import duty). A member is always free to impose a tariff that is lower than bound level. Once bound, a tariff rate becomes permanent and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade.

11) Applied Tariffs- Duty that is actually charged on imports on a Most-Favoured Nation (MFN) basis. Applied tariff should not be higher than the bound level.

12) Escalated Tariff- Tariff rates on imports of manufactured goods are higher than tariff rates on intermediate inputs and raw materials. For example, a four percent tariff on iron ore or iron ingots and twelve percent tariff on steel pipes. This type of tariff is discriminatory as it protects manufacturing industries in importing countries and adversely affects industries of exporting countries

13) Prohibitive tariff- It is set so high that no imports can enter

14) Import subsidies- It is simply a payment per unit or as percent of value for importation of a good (i.e., a negative import tariff)

15) Tariffs as Response to Trade Distortions- Countries affected by 'unfair' foreign-trade practices, respond quickly by measures in the form of tariff responses to offset the distortion. (aka "trigger-price" mechanisms)

16) Anti-dumping duty - It is a protectionist tariff that a domestic govt imposes on imports that it believes are priced below fair market value.

- Dumping occurs when manufacturers sell goods in a foreign country-
  - ❑ below the sales prices in their domestic market or
  - ❑ below their full average cost of the product.
- Dumping may also be resorted to as a predatory pricing practice to drive out domestic producers from market and to establish monopoly.
- Dumping is unfair and threat to domestic producers and thus, ADD is charged. This is justified only if the domestic industry is seriously injured by import competition, and protection is in national interest

17) Countervailing duties- CVD is charged in an importing country to offset advantage that exporters get from subsidies (from their govt.) to ensure fair pricing of imported G/S and thus protecting domestic firms.

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Effects of Tariffs

Create obstacles to trade, decrease imp & exp. Mkt access of exporting country is worsened.

2) Tariffs discourage domestic consumers from buying imported foreign goods. Domestic consumers suffer a loss in consumer surplus.

3) Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries.

4) Producers in importing country experience an increase in well being. Increases producer surplus of domestic producers.

5) The price increase induces an increase in output of the existing firms and possibly addition of new firms to industry to take advantage of high profits and consequently increase in employment.

6) Tariffs increase government revenues of importing country.

7) It discourage efficient production in rest of world and encourage inefficient prod. in home country, by disregarding comparative adv. of foreign countries.

Non - tariff measures (NTMs)

Non-tariff measures comprise all types of measures which alter the conditions of international trade, including policies and regulations that restrict trade and those that facilitate it.

Technical Measures

Technical measures refer to product-specific properties such as characteristics of the product, technical specifications and production processes.

These measures are intended for ensuring product quality, food safety, environmental protection, national security and protection of animal and plant health.

Sanitary & Phytosanitary (SPS) Measures

These are applied to protect human, animal or plant life from risks arising from additives, pests, etc. or disease-causing organisms and to protect biodiversity.

These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements. For Eg- prohibition of import of poultry from countries affected by avian flu etc

Technical Barriers to Trades (TBT)

Covers both food and non-food products - refer to mandatory 'Standards and Technical Regulations' - define specific characteristics that product should have, like size, design, packaging, etc. excluding measures covered by SPS.

Conformity assessment procedures e.g. testing, and certification) are also covered

Eg: food laws, quality standards etc

Non-Technical Measures

Non-technical measures relate to trade requirements: for example: shipping requirements, custom formalities, trade rules, taxation policies, etc.

These are further distinguished as:

1) **Hard measures** (e.g. Price and quantity control measures),
2) **Threat measures** (e.g. Anti-dumping and safeguards) and
3) **Other measures** such as trade-related finance and investment measures.
   a) **Import-related measures** - measures imposed by importing country, and
   b) **Export-related measures** - measures imposed by exporting country itself
   c) **Procedural obstacles (PO)** - practical problems in administration, transportation, delays in testing, certification etc which makes it difficult for org. to comply.

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Non – tariff Barriers (NTBs)

NTBs are discriminatory NTMs, which are used as means to circumvent free-trade rules and favour domestic industries at expense of foreign competition.

NTBs are thus a subset of NTMs that have a 'protectionist or discriminatory intent'.

Types of Non-technical measures

1) **Import Quotas**- direct restriction which specifies that only certain physical amount of good will be allowed into country during a given time period, usually one year.

a) **Binding Quota**- They are set below the free trade level of imports and are usually enforced by issuing licenses.

b) **Non-binding quota**- It is set at or above the free trade level of imports, thus having little effect on trade.

c) **Tariff rate quotas (TRQs)** combine two policy instruments namely quotas and tariffs.

d) **Absolute quotas or quotas of a permanent nature**- They limit quantity of imports to a specified level during a specified period of time and imports can take place any time of year.
   - Either no condition of country of origin of product.
   - Or Country allocation can be specified.

e) **Seasonal quotas** and

f) **Temporary quotas**

With a quota, government receives no revenue. The profits received by the holders of such import licenses are known as 'quota rents'.

If quota is set below free trade level, amount of imports will reduce. It will lower supply of good in domestic market and raise domestic price. Loss of consumer surplus & increase in producer surplus.

Types of Non-technical measures

2) **Price Control Measures**- These are steps taken to control prices of imported goods in order to support domestic price of products when import prices are lower.
Aka. **'para-tariff' measures** and include measures, other than tariff measures, that increase cost of imports by a fixed percentage or by a fixed amount.
Eg: A minimum import price established for sulphur.

3) **Non-automatic Licensing and Prohibitions**- These are aimed at limiting quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier.
These measures include non-automatic licensing, or complete prohibitions.
Eg- India prohibits import/exp of arms and related from/to Iraq.

4) **Financial Measures**- The objective is to increase import costs by regulating the access to and cost of foreign exchange for imports and to define terms of payment. It includes measures like advance payment requirements and foreign exchange controls denying use of foreign exchange for certain types of imports

5) **Measures Affecting Competition**- These measures are aimed at granting exclusive or special preferences or privileges to one or a few limited group of economic operators. It may include government imposed special import channels or enterprises, and compulsory use of national services.
Eg, a statutory marketing board may be granted exclusive rights to import wheat: or a canalizing agency (like State Trading Corp.) may be given monopoly right to distribute palm oil.

6) **Government Procurement Policies**- It involve mandates that whole of specified percentage of government purchases should be from domestic firms rather than foreign firms
In accepting public tenders, a government may give preference to local tenders rather than foreign tenders

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Types of Non-technical measures

7) **Trade-Related Investment Measures**- These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.
   a) requirement to use certain minimum levels of locally made components,
   b) restricting the level of imported components, and
   c) limiting the purchase or use of imported products to an amount related to the quantity or value of local products that it exports.

8) **Distribution Restrictions**- Limitations imposed on distribution of goods in importing country involving additional license or certification requirement. These may relate to geographical restrictions or restrictions as to the type of agents who may resell.
   Eg: a restriction that imported fruits may be sold only through outlets having refrigeration facilities.

9) **Restriction on Post-sales Services**- Producers may be restricted from providing after- sales services for exported goods in the importing country. Such services may be reserved to local service companies of the importing country.

10) **Administrative Procedures**- Costly and time-consuming administrative procedures which are mandatory for import of foreign goods. These will increase transaction costs and discourage imports.
   Examples-specifying particular procedures and formalities, requiring licenses, administrative delay, corruption in customs clearing, procedural obstacles linked to prove compliance etc.

11) **Rules of origin**- Country of origin means country in which a good was produced, or home country of service provider. Rules of origin are the criteria needed by governments of importing countries to determine the national source of a product. Duties & restrictions in some cases depend upon source of imports.

Notes:

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Types of Non-technical measures

7) **Safeguard Measures**- Measures to restrict imports of a product temporarily if its domestic industry is injured with serious injury caused by a surge in imports. These measures are for limited time and non-discriminatory

8) **Embargos**- An embargo is total ban imposed by government on import or export of some commodities to particular country for a specified period. This may be done due to political reasons or for reasons such as health, religious sentiments. This is most extreme form of trade barrier.

Export-related measures

These refer to all measures applied by government of exporting country including both technical and non-technical measures.

Ban on exports

Eg- during periods of shortages, export of agricultural products such as onion, wheat etc. may be prohibited to make them available for domestic consumption.

Export Taxes

An export tax is a tax collected on exported goods and may be either specific or ad valorem.

The effect of an export tax is to raise price of good and to decrease exports.

It increases domestic supply, it also reduces domestic prices and leads to higher domestic consumption.

Export Subsidies and Incentives

Tariffs on imports hurt exports and therefore countries have developed compensatory measures of different types for exporters like export subsidies, duty drawback, duty free access to imported intermediates etc.

Government usually provide financial contribution to domestic producers in form of grants, loans, equity infusions etc. or give some form of income or price support.

Voluntary Export Restraints

They refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time.

Such restraints originate from political considerations.

The inducement for exporter to agree to a VER is mostly to appease importing country and to avoid the effects of possible retaliatory trade restraints that may be imposed by the importer.

VERs may arise when the import competing industries seek protection from a surge of imports from particular exporting countries.

VERs cause domestic prices to rise and cause loss of domestic consumer surplus

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Regional Trade Agreements (RTAs)

RTAs are defined as groupings of countries (not necessarily belonging to the same geographical region), which are formed with the objective of reducing barriers to trade between member countries.

Types of RTAs

1) **Unilateral trade agreements**- under which an importing country offers trade incentives in order to encourage the exporting country, to engage in international economic activities that will improve the exporting country's economy. E.g. Generalized System of Preferences

2) **Bilateral Agreements**- are agreements which set rules of trade between two countries, two blocs or a bloc and a country. These may be limited to certain goods and services or certain types of market entry barriers. E.g. ASEAN-India Free Trade Area.

3) **Regional Preferential Trade Agreements**- among a group of countries reduce trade barriers on a reciprocal and preferential basis for only the members of the group. E.g. Global System of Trade Preferences among Developing Countries (GSTP)

4) **Trading Bloc**- has a group of countries that have a free trade agreement between themselves and may apply a common external tariff to other countries. Example: Arab League (AL), European Free Trade Association (EFTA)

5) **Free-trade area**- is a group of countries that eliminate all tariff and quota barriers on trade with the objective of increasing exchange of goods with each other. Members retain independence in determining their tariffs with non-members. Example: NAFTA.

Types of RTAs

6) **Customs union**- is group of countries that eliminate all tariffs on trade among themselves but maintain a common external tariff on trade with countries outside the union (thus, technically violating MFN). Eg- European Union etc

7) **Common Market**- It deepens a customs union by providing for the free flow of output and of factors of production (labour, capital and other productive resources) by reducing or eliminating internal tariffs on goods and by creating a common set of external tariffs. There are also common barriers against non-members (e.g., EU, ASEAN)

8) **Economic and Monetary Union** - Here members share a common currency. Adoption of common currency also makes it necessary to have a strong convergence in macroeconomic policies. For eg, European Union countries adopt a single currency

- The General Agreement on Tariffs and Trade (GATT) covers international trade in goods. The workings of the GATT agreement are the responsibility of the Council for Trade in Goods (Goods Council) which is made up of representatives from all WTO member countries.
- The Goods Council has 10 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures, and so on). Again, these committees consist of all member countries.

GATT lost its relevance by 1980s

1) it was obsolete to fast-evolving world trade scenario characterized by emerging globalisation
2) international investments had expanded substantially
3) intellectual property rights and trade in services were not covered
4) world merchandise trade increased by leaps and bounds and was beyond its scope.
5) the ambiguities in the multilateral system could be heavily exploited
6) efforts at liberalizing agricultural trade were not successful
7) there were inadequacies in institutional structure and dispute settlement system
8) it was not a treaty and therefore terms of GATT were binding only insofar as they are not incoherent with a nation's domestic rules.

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The Uruguay Round And The Establishment Of WTO

- The Uruguay Round brought about the biggest reform of the world's trading system.
- Members established 15 groups to work on limiting restrictions in the areas of tariffs, non-tariff barriers, tropical products, natural resource products, textiles and clothing, agriculture, safeguards against sudden 'surges' in imports, subsidies, countervailing duties, trade related intellectual property restrictions, trade related investment restrictions.
- The agreement was signed by most countries on April 15, 1994, and took effect on July 1, 1995.

Objectives of WTO

The principal objective of the WTO is to facilitate the flow of international trade smoothly, freely, fairly and predictably.

The WTO has six key objectives-

1) to set and enforce rules for international trade
2) to provide a forum for negotiating and monitoring further trade liberalization
3) to resolve trade disputes
4) to increase the transparency of decision-making processes
5) to cooperate with other major international economic institutions involved in global economic management, and
6) to help developing countries benefit fully from the global trading system.

The objectives of the WTO Agreements given in preamble of Agreement creating WTO,

- raising standards of living,
- ensuring full employment and a growth of real income and effective demand, and
- expanding the production of and trade in G/S.

Structure of the WTO

- The WTO activities are supported by a Secretariat located in Geneva, headed by a Director General.
- It has a three-tier system of decision making

1st Level (Top-Level)	Ministerial Conference	It takes decisions on all matters under any of the multilateral trade agreements. It meets at least once every two years.
2nd Level	General Council	It meets several times a year at the Geneva headquarters. It also meets as the Trade Policy Review Body and the Dispute Settlement Body.
3rd Level	Goods Council, Services Council and Intellectual Property (TRIPS) Council	These councils report to the General Council & are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialisation.

Following are the major guiding principles:

- Trade without discrimination
- The National Treatment Principle (NTP)
- Free trade
- Predictability
- Principle of general prohibition of quantitative restrictions
- Greater competitiveness
- Tariffs as legitimate measures for the protection of domestic industries
- Transparency in Decision Making
- Progressive Liberalization
- Market Access
- Special privileges to less developed countries
- Protection of Health &Environment
- A transparent, effective and verifiable dispute settlement mechanism

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Important Guiding Priniciples

1) **Trade without discrimination** : This principle states that any advantage or immunity granted by any one country to other, shall be extended immediately and unconditionally to like product originating from other countries. Under the WTO agreements, if a country lowers a trade barrier or opens up a market for one country, it has to do so for the same G/S from all other WTO members.

2) **The National Treatment Principle (NTP)** : A country should not discriminate between its own and foreign G/S. Internal taxes, internal laws, etc. applied to imported G/S, treatment should not be less favourable than that which is accorded to like domestic products must be accorded to all other members.

3) **Tariffs as legitimate measures for the protection of domestic industries:** The imposition of tariffs should be only method of protection, and tariff rates should be gradually reduced through negotiations 'on a reciprocal and mutually advantageous' basis.

4) **Market Access** : The WTO aims to increase world trade by enhancing market access by converting all non- tariff barriers into tariffs which are subject to country specific limits.

5) **A transparent, effective and verifiable dispute settlement mechanism:** Trade relations frequently involve conflicting interests. Any dispute arising out of violation of trade rules are to be settled through consultation. In case of failures, the dispute can be referred to WTO and can pursue a stage-by-stage procedure that includes a judgment by a panel of experts, and opportunity to appeal the ruling on legal grounds. The decisions of the dispute settlement body are final and binding

Overview of the WTO agreements

1) Agreement on Agriculture
2) Agreement on Application of Sanitary and Phytosanitary (SPS) Measures
3) Agreement on Textiles and Clothing
4) Agreement on Technical Barriers to Trade (TBT)
5) Agreement on Trade-Related Investment Measures (TRIMs)
6) Anti-Dumping Agreement
7) Customs Valuation Agreement
8) Agreement on Pre-shipment Inspection (PSI)
9) Agreement on Rules of Origin
10) Agreement on Import Licensing Procedures
11) Agreement on Subsidies and Countervailing Measures
12) Agreement on Safeguards
13) General Agreement on Trade in Services (GATS)
14) Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
15) Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)
16) Trade Policy Review Mechanism (TPRM)
17) Plurilateral Trade Agreements
    a) Agreement on Trade in Civil Aircraft
    b) Agreement on Government Procurement

The Doha Round

- The Doha Round was 9th round since Second World War was officially launched at the WTO's Fourth Ministerial Conference in Doha, Qatar, in Nov 2001.
- The round seeks to accomplish major modifications of the international trading system through lower trade barriers and revised trade rules.
- The negotiations include 20 areas of trade.
- Most controversial topic here was agriculture trade.

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G 20 ECONOMIES: FACILITATING TRADE

- While some **trade-restrictive measures have been lifted by G20 countries**, the report indicates that the **trend has been going in the wrong direction.**
- Export **restrictions contribute** to **shortages, price volatility,** and **uncertainty.**
- The report indicates that **supply chains** on the whole have thus far proved to be **resilient,** despite the **war in Ukraine,** the **continuing impacts of the COVID-19 pandemic,** the **highest inflation many countries have experienced** in decades, and the **impacts of monetary tightening** by **central banks** seeking to **limit price increases.** That said, specific industries and regions have been differently impacted.
- Overall, the pace of **implementation of new export restrictions by WTO** members has increased since 2020, first in the context of the pandemic and subsequently with the **war in Ukraine and the food crisis.** Some of these **export restrictions have been gradually lifted,** but several still remain in place.
- As of **mid-October 2022,** WTO members still had in place 52 export restrictions on food, feed and fertilizers, in addition to 27 export restrictions on products essential to combat COVID- 19. Of these, 44% of the export restrictions on food, feed and fertilizers, and **63% of the pandemic-related export restrictions, were maintained by G20 economies.**
- During the review period, **G20 economies introduced 66 new trade-facilitating measures** (covering trade worth USD 451.8 billion) and **47 trade-restrictive measures** on **goods** (with a trade coverage of USD 160.1 billion). These **measures** were **not related to the pandemic.**
- At the same time, the accumulated stockpile of G20 import restrictions continued to grow. By **mid-October, 11.6% of G20 imports were affected** by **trade-restricting measures implemented since 2009 and still in force.**
- **Initiations of trade remedy investigations** by G20 economies **declined sharply during the review period** (17 initiations), after a peak in 2020 that was the highest since the beginning of the trade monitoring exercise in 2009. **Anti-dumping measures continued to be the most frequent trade remedy action** in terms of initiations and terminations.
- Similarly, the **implementation of new COVID-19-related trade measures** by **G20 economies decelerated over the past five months,** with four new such measures recorded on goods and one on services. The number of new COVID-19-related support measures to mitigate the social and economic impacts of the pandemic also fell sharply over the past five months.
- Since the beginning of the pandemic, **201 COVID-19 trade and trade-related measures in goods were implemented by G20 economies.** Most (61%) were trade facilitating, while the rest (39%) could be considered trade restrictive.
- G20 economies also continued to phase out pandemic-related import and export measures. By mid-October 2022, **77% of export restrictions had been repealed, leaving 17 restrictions in place.** Although the number of the pandemic-related trade restrictions in place decreased, their trade coverage remained significant, at **USD 122.0 billion.**
- The WTO trade monitoring reports have been prepared by the WTO Secretariat since 2009.
- **G20 members are**: Argentina; Australia; Brazil; Canada; China; the European Union; France; Germany; India; Indonesia; Italy; Japan; the Republic of Korea; Mexico; the Russian Federation; Saudi Arabia; South Africa; Türkiye; the United Kingdom; and the United States.

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Foreign Exchange

It refers to money denominated in a currency other than the domestic currency. Similar to any other commodity, foreign exchange has a price.

Exchange rate

Aka. foreign exchange (FX) rate, is price of one currency expressed in terms of units of another currency. It represents the minimum number of units of one country's currency required to purchase one unit of the other country's currency.

2 ways to express nominal exchange rate-

1)Direct Quote (European Currency Quotation)
It is number of units of a local currency exchangeable for one unit of a foreign currency

Foreign currency (USD) = base currency Domestic currency (INR) = counter currency

Eg: USD 1 = INR 75

2) Indirect Quote (American Currency Quotation)
Domestic currency (INR) = base currency
foreign currency (USD) = counter currency.

Indirect Quote = 1 / Direct Quote

Eg: INR 1 = USD 0.013

A foreign currency transaction is a transactions arising when an enterprise either:
a) buys or sells goods or services whose price is denominated in a foreign currency.
b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
c) becomes a party to an unperformed forward exchange contract; or

THE EXCHANGE RATE REGIMES

- Exchange rates are determined by demand and supply. But governments can influence those exchange rates in various ways. The extent and nature of government involvement in currency markets define alternative systems of exchange rates.
- **There are three broad categories of exchange rate systems.**
  1. In one system, exchange rates are set purely by private market forces with no government involvement. Values change constantly as the demand for and supply of currencies fluctuate.
  2. In another system, currency values are allowed to change, but governments participate in currency markets in an effort to influence those values.
  3. Finally, governments may seek to fix the values of their currencies, either through participation in the market or through regulatory policy.
- An exchange rate regime is the system by which a country manages its currency with respect to foreign currencies. It refers to the method by which the value of the domestic currency in terms of foreign currencies is determined.
- **There are two major types of exchange rate regimes at the extreme ends;**

i. floating exchange rate regime (also called a flexible exchange rate), and
ii. fixed exchange rate regime

- **In a free-floating exchange rate system,** governments and central banks do not participate in the market for foreign exchange. The relationship between governments and central banks on the one hand and currency markets on the other is much the same as the typical relationship between these institutions and stock markets. Governments may regulate stock markets to prevent fraud, but stock values themselves are left to float in market.
- A free-floating system has the advantage of being self-regulating. There is no need for government intervention if the exchange rate is left to the market. Market forces also restrain large swings in demand or supply.
- The primary difficulty with free-floating exchange rates lies in their unpredictability. Fluctuating exchange rates make international transactions riskier & increase the cost of doing business with other countries.

Managed Float Systems

- Governments and central banks often seek to increase or decrease their exchange rates by buying or selling their own currencies. Exchange rates are still free to float, but governments try to influence their values.
- Government or central bank participation in a floating exchange rate system is called a **managed float.**
- Countries that have a floating exchange rate system intervene from time to time in currency market in an effort to raise or lower price of their own currency. Typically, the purpose of such intervention is to prevent sudden large swings in the value of a nation's currency.
- Still, governments or central banks can sometimes influence their exchange rates.

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CHAPTER 9 - International Trade | UNIT 4 - Exchange Rates and its Economic Effects

Two major types of exchange rate regimes

Floating exchange rate regime (aka. flexible exchange rate)

- Basically, the **free floating or flexible exchange rate regime** is argued to be efficient and highly transparent as the exchange rate is free to fluctuate in response to the supply of and demand for foreign exchange in the market and clears the imbalances in the foreign exchange market without any control of the central bank or the monetary authority.

Fixed exchange rate regime (aka. pegged exchange rate)

- In a fixed exchange rate system, the exchange rate between two currencies is set by government policy. There are several mechanisms through which fixed exchange rates may be maintained. Whatever the system for maintaining these rates, however, all fixed exchange rate systems share some important features.

Floating Rate

Advantages

1) Allows a Central bank or government to pursue its own independent monetary policy.
2) Allows exchange rate to be used as a policy tool: for example, policy-makers can adjust the nominal exchange rate to influence the competitiveness of the tradable goods sector.
3) No obligation to intervene in currency markets, the central bank is not required to maintain a huge foreign exchange reserves. (unlike fixed exchange rate regime)

Disadvantages

1) Volatile exchange rates generates a lot of uncertainties in relation to international transactions and
2) It adds a risk premium to the costs of goods and assets traded across borders.

Fixed Rate

Advantages

1) Avoids currency fluctuations & eliminates exchange rate risks & transaction costs thus making international trade less risky
2) Reduced speculation on exch rate movement
3) Imposes discipline on a country's monetary authority and generates lower inflation.
4) Govt can encourage greater trade and investment as stability encourages investment.
5) Pegging enhances credibility of the country's monetary-policy (more stable)

Disadvantages

1) Lacks flexibility
2) Central bank is required to stand ready to intervene and maintain huge foreign exchange reserves for this purpose

Central bank can implement **soft peg** and **hard peg** policies.

Soft peg

A soft peg refers to an exchange rate policy under which the exchange rate is generally determined by the market, but in case the exchange rate tends to be move speedily in one direction, the central bank will intervene in the market.

Hard peg

With a hard peg exchange rate policy, the central bank sets a fixed and unchanging value for the exchange rate. Both soft peg and hard peg policy require that the central bank intervenes in the foreign exchange market.

Nominal Vs. Real Exchange Rates

Nominal Exchange Rate

- It refers to the rate at which a person can trade the currency of one country for the currency of another country.
- For any country, there are many nominal exchange rates because its currency can be used to purchase many foreign currencies.

Real Exchange Rate

- It is the rate at which a person can trade goods & services of one country for goods and services of another.
- It describes 'how many' of a good or service in one country can be traded for 'one' of that good or service in a foreign country.

$$\text{Real exchange Rate} = \text{Nominal exchange rate} \times \frac{\text{Domestic Price*}}{\text{Foreign price}}$$

Real Effective Exchange Rate (REER)

- It is the nominal effective exchange rate (a measure of the value of a domestic currency against a weighted average of various foreign currencies) divided by a price deflator or index of costs.
- An increase in REER implies that exports become more expensive and imports become cheaper; thus, an increase in REER indicates a loss in trade competitiveness.

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THE FOREIGN EXCHANGE MARKET

- Forex market participants mainly are commercial banks executing orders from exporters, importers, investment institutions, insurance and retirement funds, hedgers, and private investors.
- Brokerage houses are also playing an important role as contractors between large numbers of banks, funds, commission houses, dealing centers, etc.
- Commercial Banks and Brokerage Houses do not only execute currency exchange operations at prices set by other active players but come out with their own prices as well, actively influencing the price formation process and the market life. That is why they are called market makers.
- In contrast to the above, passive players cannot set their own quotations and make trades at quotations offered by active market players.
- Passive market players normally pursue the following aims: payment of export-import contracts, foreign industrial investments, the opening of branches abroad or the creation of joint ventures, tourism, speculation on rate difference, hedging of currency risks (insurance against losses in case of unfavorable price changes), etc.

Requirement / Need of foreign currency

On the demand side

- purchase goods and services from another country
- for unilateral transfers such as gifts, awards, grants, donations or endowments
- to make investment income payments abroad
- to purchase financial assets, stocks or bonds abroad
- to open a foreign bank account
- to acquire direct ownership of real capital, and
- for speculation and hedging activities related to risk-taking or risk avoidance activity

On the supply side

- purchases of home exports,
- unilateral transfers to home country, investment income payments, foreign direct
- investments and portfolio investments, placement of bank deposits and
- speculation.

Foreign exchange market

Two types of transactions:

Current Transactions
They are carried out in the spot market and the exchange involves immediate delivery

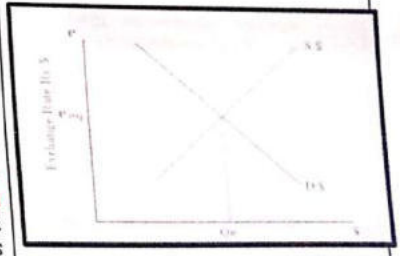
Future Transactions
Here contracts are agreed upon to buy or sell currencies for future delivery which are carried out in forward and/or futures markets

Other Terms

1) **Spot Exchange Rates:** Exchange rates prevailing for spot trading (for which settlement by and large takes two days).
2) **Forward Exchange Rates:** The exchange rates quoted in foreign exchange transactions that specify a future date

Diagram, explaining how nominal exchange rate between two countries is determined

- Similar to any standard market, the exchange market also faces a downward-sloping demand curve and an upward-sloping supply curve.
- The equilibrium rate of exchange is determined by the interaction of the supply and demand for a particular foreign currency. In figure above, the demand curve (D$) and supply curve (S$) of dollars intersect to determine equilibrium exchange rate eeq with Qe as the equilibrium quantity of dollars exchanged.



Determination of Nominal Exchange Rate

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Changes in exchange rates

Appreciation

Currency appreciates when its value increases with respect to value of another currency

Example
Old Rate → $ 1 = Rs 73
New Rate → $ 1 = Rs 69
Here, Indian Rupee is appreciating & US Dollar is depreciating

Depreciation

Currency depreciates when its value falls with respect to the value of another currency

Example
Old Rate → $ 1 = Rs 70
New Rate → $ 1 = Rs 75
Here, Indian Rupee is depreciating & US Dollar is appreciating

Home Currency Appreciates

Exporter of Domestic Country	
Importer of Domestic Country	

Home Currency Depreciates

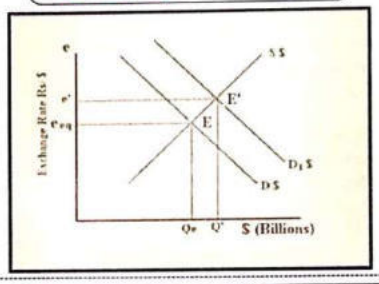
Exporter of Domestic Country	
Importer of Domestic Country	

	Devaluation	Depreciation
1.	Devaluation is a deliberate downward adjustment in the value of a country's currency relative to another country's currency due to government intervention	Depreciation is a decrease in a currency's value with respect to other currencies due to market forces of demand and supply
2.	Occurs in fixed exchange rate system	Occurs in floating exchange rate system
3.	Revaluation, opposite of devaluation, refers to a deliberate increase in value of a nation's currency.	Appreciation, opposite of depreciation, is an increase in a currency's value with respect to other currencies due to market forces of demand and supply

Changes in exchange rates under Floating Rate System

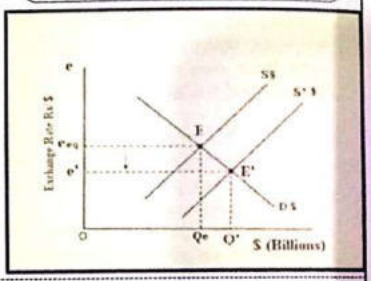
Demand of foreign currency increase, Supply remains unchanged

The exchange value of foreign currency rises and the domestic currency depreciates in value



Supply of foreign currency increase, Demand remains unchanged

The exchange value of foreign currency falls and the domestic currency appreciates in value



Impacts of currency depreciation

1) Windfall gains for export-oriented sectors
2) Remittances to homeland by non-residents and businesses abroad fetches more in terms of domestic currency
3) Enhance government revenues from import related taxes
4) Results in high amount of local currency for a given amt of foreign currency borrowings of government.
5) Positive impact on country's trade deficit as it makes imports expensive & exports cheaper
6) Depreciation also can have a positive impact on controlling spiralling gold imports and improve trade balance.

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Other Terms

1) **Currency forward contracts-** They are quoted just like spot rate; however, the actual delivery of currencies takes place at specified time in future. When a party agrees to sell euro for dollars on a future date at a forward rate agreed upon, he has 'sold euros forward' and 'bought dollars forward'.
2) **Forward Premium** = Forward exch rate > spot exch rates
3) **Forward Discount** = Forward exch rate < spot exch rates
4) **Vehicle Currency-** While a foreign exchange transaction can involve any two currencies, most transactions involve exchanges of foreign currencies for the U.S. dollars even when it is not the national currency of either the importer or the exporter. On account of its critical role in the forex markets, the dollar is often called a 'vehicle currency'.

IMPACTS OF EXCHANGE RATE FLUCTUATIONS ON DOMESTIC ECONOMY

The developments in the foreign exchange markets affect the domestic economy both directly and indirectly. The direct impact of fluctuations in rates is initially felt by economic agents who are directly involved in international trade or international finance.

i. Fluctuations in the exchange rate have a significant role in determining the nature and extent of a country's trade.
ii. Fluctuations in the exchange rate affect the economy by changing the relative prices of domestically-produced and foreign-produced goods and services. All else equal (or other things remaining the same), an appreciation of a country's currency raises the relative price of its exports and lowers the relative price of its imports. Conversely, depreciation lowers the relative price of a country's exports and raises the relative price of its imports.
iii. Exchange rate changes affect economic activity in the domestic economy. A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods. Increased demand, both for domestic import-competing goods and for exports, encourages economic activity and creates output expansion.
iv. For an economy where exports are significantly high, a depreciated currency would mean a lot of gain. In addition, if exports originate from labour-intensive industries, increased export prices will have positive effect on employment and potentially on wages.
v. Depreciation is also likely to add to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods. The impact will be greater if the composition of domestic consumption baskets consists more of imported goods. Indirectly, cost push inflation may result through possible escalation in the cost of imported inputs. The fiscal health of a country whose currency depreciates is likely to be affected with rising export earnings and import payments and consequent impact on current account balance. Companies that have borrowed in foreign exchange through external commercial borrowings (ECBs) but have been careless and did not sufficiently hedge these loans against foreign exchange risks, would also be negatively impacted as they would require more domestic currency to repay their loans. A depreciated domestic currency would also increase their debt burden and lower their profits and impact their balance sheets adversely. These would signal investors who will be discouraged from investing in such companies.
vi. Countries with foreign currency denominated government debts, currency depreciation will increase interest burden and cause strain to exchequer for repaying and servicing foreign debt. Fortunately, India's has small proportion of public debt in foreign currency.
vii. Exchange rate fluctuations make financial forecasting more difficult for firms and larger amounts will have to be earmarked for insuring against exchange rate risks through hedging.
viii. With growth of investments across international boundaries, exchange rates have assumed special significance. Depreciating currency hits investor sentiments and has radical impact on patterns of international capital flows.
ix. Foreign investors are likely to be indecisive or highly cautious before investing in a country that has high exchange rate volatility. Foreign capital inflows are characteristically vulnerable when local currency weakens.

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Impacts of currency appreciation

1) It raises the price of exports and, therefore, the quantity of exports would fall. Since imports become cheaper, we may expect an increase in the quantity of imports Thus domestic aggregate demand falls and, therefore, economic growth is likely to be negatively impacted

2) Appreciation in recessionary phase→ fall in aggregate demand & higher unemployment
Appreciation in boom phase→ decrease in inflation
soften growth rate of economy

3) It leads to lower inflation because imports are cheaper. Lower price of imported inputs lead to decrease in cost of production , thus decrease prices of output & increase std of living

4) With increasing export prices, the competitiveness is adversely affected and therefore, firms have incentives to introduce technological innovations and capital-intensive production to cut costs to remain competitive

5) Increasing imports and declining exports are liable to cause larger deficits and worsen the current account

6) Loss of competitiveness will be insignificant if currency appreciation is because of strong fundamentals of the economy.

Notes

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The term '**foreign capital**' is a comprehensive one and includes any **inflow of capital into the home country from abroad** and therefore, we need to be clear about the distinction between movement of capital and foreign investment **Foreign capital may flow into an economy in different ways**

Components of foreign capital flows

Foreign aid or assistance
- Bilateral or direct inter government grants
- Multilateral aid from many governments who pool funds with international organizations like the World Bank
- Tied aid with strict mandates regarding the use of money or untied aid where there are no such stipulations
- Foreign grants which are voluntary transfer of resources by governments, institutions, agencies or organizations

Borrowings
- Direct inter government loans
- Loans from international institutions (e.g. world bank, IMF, ADB)
- Soft loans for e.g. from affiliates of World Bank such as IDA
- External commercial borrowing, [ECBs are loans in India made by non-resident lenders in foreign currency to Indian borrowers] and
- Trade credit facilities

International Investments
- Foreign portfolio investment (FPI) in bonds, stocks and securities, and
- Foreign direct investment (FDI) in industrial, commercial and similar other enterprises

Deposits from non-resident Indians (NRI)

Foreign Direct Investment

FDI is defined as process whereby resident of one country (i.e. home/source country) acquires ownership of asset in another country (i.e host country) & such movement of capital involves ownership, control as well as management of asset.

FDI, according to **IMF manual on 'Balance of payments'** is "all investments involving long-term relationship & reflecting lasting interest & control of resident entity in a economy in an enterprise resident in economy other than that of direct investor".

According to IMF and OECD definitions, it typically occurs through **acquisition of more than 10 percent of the shares of the target asset.** Direct investment comprises not only the initial transaction establishing the relationship but also all subsequent transactions between them and among affiliated enterprises.

Components of FDI
1) Equity capital
2) Reinvested earnings
3) Other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises

Foreign direct investors
1) individuals,
2) incorporated or unincorporated private or public enterprises,
3) associated groups of individuals or enterprises,
4) governments or government agencies, estates, trusts, or other organizations
5) or any combination of above

Forms of direct investments / Modes Of FDI
1) the opening of overseas companies,
2) including the establishment of subsidiaries or branches,
3) creation of joint ventures on a contract basis or M&A
4) joint development of natural resources and
5) purchase of companies in country receiving foreign capital
6) Green field investment (freshly starting production)
7) Brownfield investments (using existing infrastructure by merging)

FDI may be categorized as

Horizontal Agreements
When the investor establishes the same type of business operation in a foreign country as it operates in its home country.

For example, a cell phone service provider based in the United States moving to India to provide the same service.

Vertical Agreements
When the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity.

For example, an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company

Conglomerate Agreements
When an investor makes a foreign investment in a business that is unrelated to its existing business in its home country.

This is often in form of a joint venture with a foreign firm already operating in the industry, as investor has no previous experience.

Two - way direct foreign investments
These are reciprocal investments between countries.

These investments occur when some industries are more advanced in one nation (for example, computer industry in USA) while other industries are more efficient in other nations (such as automobile industry in Japan).

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Foreign Portfolio Investment

FPI flow of 'financial capital' rather than 'real capital' and it does not involve ownership or control on the part of investor.
Eg of FPI are deposit of funds in India by an Italian company etc

Unlike FDI, portfolio capital, moves to investment in financial stocks, bonds and other financial instrument and is effected by institutions through mechanism of capital market.

FPI has immediate effects on balance of payments or exchange rates.

It is not concerned with either manufacture of goods or with provision of services.

portfolio investments are characterised by lower stake in companies with their total stake in a firm at below 10 percent

Foreign direct investment (FDI)	Foreign direct investment (FDI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not inclined to be speculative	Speculative in nature
Often accompanied by technology transfer	Not accompanied by technology transfer
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages
Enduring interest in management and control	No abiding interest in management and Control
Securities are held with significant degree of influence by the investor on the management of the Enterprise	Securities are held purely as a financial investment and no significant degree of influence on the management of the Enterprise

Reasons For FDI

1) Opportunity to generate profits available in other countries.
2) Expectation of higher rate of return than what is possible in the home country.
3) Some firm-specific knowledge or assets (such as superior management skills or an important patent) that gives foreign firms a competitive edge
4) Increasing interdependence of national economies
5) Internationalisation of production
6) Reap economies of large-scale operation
7) Lack of feasibility of licensing agreements with foreign producers
8) Necessity to retain direct control of production knowledge & trade patents
9) Procure a promising foreign firm to avoid future competition
10) Risk diversification
11) Shared common language and possible saving in time and transport costs (due to geographical proximity)

Deterrents to FDI

❑ **Poor macro-economic environment**
Infrastructure lags, high rates of inflation and continuing instability, balance of payment deficits, exchange rate volatility, unfavourable tax regime (including double taxation), small size of market

❑ **Unfavourable resource and labour market conditions**
Poor natural and human resources, low literacy, low labour skills

❑ **Unfavourable legal and regulatory framework**
Absence of well-defined property rights, lack of security to life and property, stringent regulations, cumbersome legal formalities and delays

❑ **Lack of host country trade openness**
lack of openness, prevalence of non-tariff barriers, lack of a general spirit of friendliness towards foreign investors

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Host Country Determinants of Foreign Direct Investment

Economic Determinants	Policy Framework
Market -seeking FDI:	
➢ Market size and per capita income ➢ Market growth ➢ Access to regional and global markets ➢ Country-specific consumer preferences Structure of markets	➢ Economic, political, and social stability ➢ Rules regarding entry and operations ➢ Standards of treatment of foreign affiliates
Resource - or asset-seeking FDI:	
➢ Raw materials ➢ Low -cost unskilled labor Availability of skilled labor ➢ Technological, innovative, and other created assets (e.g., brand names) ➢ Physical infrastructure	➢ Policies on functioning and structure of markets (e.g., regarding ➢ competition, mergers) ➢ International agreements on FDI Privatization policy ➢ Trade policies and coherence of FDI and trade policies ➢ Tax policy
Efficiency -seeking FDI:	**Business Facilitation**
➢ Costs of above physical and human resources and assets ➢ (including an adjustment for productivity) ➢ Other input costs (e.g., intermediate products, transport costs) ➢ Membership of country in a regional integration agreement, which could be conducive to forming regional corporate networks	➢ Investment promotion (including image building and investment-generating activities and investment-facilitation services) ➢ Investment incentives ➢ "Hassle costs" (related to corruption and administrative efficiency) ➢ Social amenities (e.g., bilingual schools, quality of life) ➢ After-investment services

Factors in the host country discouraging inflow of foreign investments are

- ➢ infrastructure lags,
- ➢ high rates of inflation,
- ➢ balance of payment deficits,
- ➢ poor literacy and low labour skills,
- ➢ rigidity in the labour market,
- ➢ bureaucracy and corruption,
- ➢ unfavourable tax regime,
- ➢ cumbersome legal formalities and delays,
- ➢ Difficulties in contract enforcement
- ➢ land acquisition issues,
- ➢ small size of market and lack of potential for its growth,
- ➢ political instability
- ➢ absence of well-defined property rights,
- ➢ exchange rate volatility,
- ➢ poor track-record of investments,
- ➢ prevalence of non-tariff barriers,
- ➢ stringent regulations,
- ➢ lack of openness,
- ➢ language barriers,
- ➢ high rates of industrial disputes,
- ➢ lack of security to life and property,
- ➢ double taxation and lack of a general spirit of friendliness towards foreign investors.

MODES OF FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investments can be made in a variety of ways, such as:

i. **Opening of a subsidiary** or **associate company** in a **foreign country**,
ii. **Equity injection** into an overseas company,
iii. **Acquiring a controlling interest in an existing foreign company**, **Mergers** and **acquisitions**(M&A)
iv. **Joint venture** with a foreign company.
v. **Green field investment** (establishment of a new overseas affiliate for freshly starting production by a parent company).
vi. **Brownfield investments** (a form of FDI which makes use of the existing infrastructure by merging, acquiring or leasing, instead of developing a completely new one .

For e.g. in India 100% FDI under automatic route is allowed in Brownfield Airport projects.

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Important Benefits Of FDI

1. Competition for FDI among national governments also has helped to promote political and structural reforms important to attract foreign investors, including legal systems and macroeconomic policies.
2. There is also greater possibility for the promotion of ancillary units resulting in job creation and skill development for workers.
3. Foreign enterprises possessing marketing information with their global network of marketing are in a unique position to utilize these strengths to promote the exports of developing countries. If the foreign capital produces goods with export potential, the host country is in a position to secure scarce foreign exchange needed to import capital equipments or materials to assist the country's development plans or to ease its external debt servicing.
4. If the host country is in a position to implement effective tax measures, the foreign investment projects also would act as a source of new tax revenue which can be used for development projects.
5. It is likely that foreign investments enter into industries in which economies of scale can be realized so that consumer prices may be reduced. Domestic firms might not always be able to generate the necessary capital to achieve the cost reductions associated with large-scale production.
6. Increased competition resulting from the inflow of foreign direct investments facilitates weakening of the market power of domestic monopolies resulting in a possible increase in output and fall in prices.
7. Since FDI has a distinct advantage over the external borrowings, it is considered to have a favourable impact on the host country's balance of payment position, and
8. Better work culture and higher productivity standards brought in by foreign firms may possibly induce productivity related awareness and may also contribute to overall human resources development.

Following are the general arguments put forth against the entry of foreign capital:

1. FDIs are likely to concentrate on capital-intensive methods of production and service so that they need to hire only relatively few workers. Such technology is inappropriate for a labour-abundant country as it does not support generation of jobs which is a crucial requirement to address the two fundamental areas of concern for the less developed countries namely, poverty and unemployment
2. The inherent tendency of FDI flows to move towards regions or states which are well endowed in terms of natural resources and availability of infrastructure has the potential to accentuate regional disparity. Foreign capital is also criticized for accentuating the already existing income inequalities in the host country.
3. In the context of developing countries, it is usually alleged that the inflow of foreign capital may cause the domestic governments to slow down its efforts to generate more domestic savings, especially when tax mechanisms are difficult to implement. If the foreign corporations are able to secure incentives in the form of tax holidays or similar provisions, the host country loses tax revenues.
6. FDI is also held responsible by many for ruthless exploitation of natural resources and the possible environmental damage.
7. With substantial FDI in developing countries there is a strong possibility of emergence of a dual economy with a developed foreign sector and an underdeveloped domestic sector.
8. FDI usually involves domestic companies 'off –shoring', or shifting jobs and operations abroad in pursuit of lower operating costs and consequent higher profits. This has deleterious effects on employment potential of home country.
9. Foreign entities are usually accused of being anti-ethical as they frequently resort to methods like aggressive advertising and anticompetitive practices which would induce market distortions.
10. FDI may have adverse impact on the host country's commodity terms of trade (defined as the price of a country's exports divided by the price of its imports).

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FOREIGN DIRECT INVESTMENT IN INDIA

- Foreign Direct Investment (FDI), in addition to being a **key driver of economic growth**, has been a significant non-debt financial resource for India's economic development. Foreign corporations invest in India to benefit from the country's particular investment privileges such as **tax breaks** and **comparatively lower salaries**.
- This helps India develop **technological know- how** and **create jobs** as well as **other benefits**. These investments have been coming into India because of the **government's supportive policy framework, vibrant business climate, rising global competitiveness and economic influence.**
- The government has recently made numerous efforts, including easing FDI regulations in various industries, PSUs, oil refineries, telecom and defence.
- India's FDI inflows reached record levels during 2020-21. The total FDI inflows stood at US$ 81,973 million, a 10% increase over the previous financial year. According to the World Investment Report 2022, India was ranked eighth among the world's major FDI recipients in 2020, up from ninth in 2019. Information and technology, telecommunication and automobile were the major receivers of FDI in FY22. With the help of significant transactions in the technology and health sectors, multinational companies (MNCs) have pursued strategic collaborations with top domestic business groupings, fuelling an increase in cross-border M&A of 83% to US$ 27 billion.

OVERSEAS DIRECT INVESTMENT BY INDIAN COMPANIES

- India is primarily a domestic demand-driven economy, with **consumption** and **investments** contributing to **70% of the economic activity**. With an improvement in the economic scenario and the Indian economy recovering from the Covid-19 pandemic shock, India is relatively well placed than the rest of the world. Despite major headwinds that continue to pose risks in the short term, the **Indian economy has remained strong owing to robust policy measures in place.**
- This gives **Indian businesses an advantage** to make **investments abroad** and broaden their operational footprint in such nations. **New innovations** from abroad would be **brought to India** with the **help of knowledge spillover**, and **India itself would contribute to the growth of other nations**. In this manner, a **mutual benefit** is achieved.

Some of the key overseas investments and developments that have taken place in the recent past are mentioned as follows:
According to data released by the Reserve Bank of India (RBI), overseas direct investment stood at US$ 1,922.51 million in September 2022.

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CA Foundation - New Syllabus

Business Economics - Paper 4

SUPER CHART BOOK by MVSIR

Chapter 10
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CHAPTER 10 - INDIAN ECONOMY

STATUS OF INDIAN ECONOMY: PRE INDEPENDENCE PERIOD (1850 -1947)

- Between the first and the seventeenth century AD, India is believed to have had the largest economy of the ancient and the medieval world. It was prosperous and self-reliant and is believed to have controlled between one third and one fourth of the world's wealth.
- The economy consisted of self-sufficient villages as well as cities which were centres of commerce, pilgrimage and administration. Compared to villages, cities presented more opportunities for diverse occupations, trades and gainful economic activities.
- Simple division of labour intertwined with attributes such as race, class, and gender was the basis of the structure of the villages and acted as a built-in mechanism of economic and social differentiation.
- Though agriculture was the dominant occupation and the main source of livelihood for majority of people, the country had a highly skilled set of artisans and craftsmen who produced manufactures, handicrafts and textiles of superior quality and fineness for the worldwide market.

Box.1 Ancient Economic Philosophy of India

- The earliest known treatise on ancient Indian economic philosophy is 'Arthashastra' the pioneering work attributed to Kautilya (Chanakya) (321-296 BCE)Arthashastra is recognized as one of the most important works on statecraft in the genre of political philosophy. It is believed to be a kind of handbook for King Chandragupta Maurya, the founder of Mauryan empire, containing directives as to how to reign over the kingdom and encouraging direct action in addressing political concerns without regard for ethical considerations.
- Artha is not wealth alone; rather it encompasses all aspects of the material well-being of individuals. Arthashastra is the science of 'artha' or material prosperity, or "the means of subsistence of humanity," which is, primarily, 'wealth' and, secondarily, 'the land'.
- The major focus of the work is on the means of fruitfully maintaining and using land. Kautilya emphasizes the importance of robust agricultural initiatives for an abundant harvest which will go toward filling the state's treasury. Taxes, which were charged equal for private and state-owned businesses, must be fair to all and should be easily understood by the king's subjects.
- Being a multidisciplinary discourse on areas such as politics, economics, military strategy, diplomacy, function of the state, and the social organization, Kautilya's writings relate to statecraft, political science, economic policy and military strategy. True kingship is defined as a ruler's subordination of his own desires and ambitions to the good of his people; i.e. a king's policies should reflect a concern for the greatest good of the greatest number of his subjects. The preservation and advancement of this good was comprised of seven vital elements, namely the King, Ministers, Farmlands, Fortresses, Treasury, Military and the Allies.

The advent of the Europeans and the British marked a shift in the economic history of India. The period of British rule can be divided into two sub periods:

1) The rule of East India Company from 1757 to 1858
2) British government in India from 1858 to 1947

The historical legacy of British colonialism is an important starting point to illustrate the development path of India. With the onset of Industrial revolution in the latter half of the 18th century, the manufacturing capabilities of Britain increased manifold, and consequently there arose the need to augment raw material supply as well as the need for finding markets for finished goods. This led to a virtual reversal of the nature of India's foreign trade from an exporter of manufactures to an exporter of raw materials.

- The Indian exports of finished goods were subjected to heavy tariffs and the imports were charged lower tariffs under the policy of discriminatory tariffs followed by the British. This made the exports of finished goods relatively costlier and the imports cheaper. In this backdrop, the Indian goods lost their competitiveness.

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- Consequently, the external as well as the domestic demand for indigenous products fell sharply culminating in the destruction of Indian handicrafts and manufactures.
- The destruction of Indian manufactures, mainly due to the hostile imperial policies to serve the British interests and the competition from machine-made goods, had far reaching adverse consequences on the Indian manufacturing sector.
- The problem was aggravated by the shift in patterns of demand by domestic consumers favouring foreign goods as many Indians wanted to affiliate themselves with western culture and ways of life.

- The damage done to the long established production structure had far reaching economic and social consequences as it destroyed the internal balance of the traditional village economy which was characterized by the harmonious blending of agriculture and handicrafts. These were manifest as:

1. Large scale unemployment and absence of alternate sources of employment which forced many to depend on agriculture for livelihood
2. The increased pressure on land caused sub division and fragmentation of land holdings, subsistence farming, reduced agricultural productivity and poverty.
3. The imports of cheap machine made goods from Britain and an overt shift of tastes and fashion of Indians in favour of imported goods made the survival of domestic industries all the more difficult.
4. The systems of land tenure, especially the zamindari system created a class of people whose interests were focused on perpetuating the British rule.
5. Excessive pressure on land increased the demand for land under tenancy, and the zamindars got the opportunity to extract excessive rents and other payments.
6. Absentee landlordism, high indebtedness of agriculturists, growth of a class of exploitative money lenders and low attention to productivity enhancing measures led to a virtual collapse of Indian agriculture.

- We shall now have a look into the stagnated nature of industrialisation during the colonial era. Factory-based production did not exist in India before 1850.The 'Modern' industrial enterprises in colonial India started to grow in the mid-19th century. The cotton milling business grew steadily throughout the second half of the 19th century, and achieved high international competitiveness. The cotton mill industry in India had 9 million spindles in the 1930s, which placed India in the fifth position globally in terms of number of spindles.
- Jute mills also expanded rapidly in and around Calcutta in response to a mounting global demand for ropes and other products, and Indian jute occupied a large share of the international market by the late 19th century.
- At the end of the 19th century, the Indian jute mill industry was the largest in the world in terms of the amount of raw jute consumed in production. In addition, brewing, paper-milling, leather-making, matches, and rice-milling industries also developed during the century.
- Heavy industries such as the iron industry were also established as early as 1814 by British capital. India's iron industry was ranked eighth in the world in terms of output in 1930. Due to progress in modern industrial enterprises, some industries even reached global standards by the beginning of the 20th century.
- Just before the Great Depression, India was ranked as the twelth largest industrialised country measured by the value of manufactured products.
- The producer goods industries, however, did not show high levels of expansion. Perhaps, the most important of the factors that led to this state of affairs was the pressure exerted by the English producers in matters of policy formulation to positively discourage the development of industries which were likely to compete with those of the English producers.
- India's industrial growth was insufficient to bring in a general transformation in its economic structure. The share in the net domestic product (NDP) of the manufacturing sector (excluding small scale and cottage industries) had barely reached 7% even in 1946.Considering its slow progress, the share of factory employment in India was also small (i.e. 0.4% of the total population in 1900 and 1.4% in 1941).

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CHAPTER 10 - INDIAN ECONOMY

INDIAN ECONOMY: POST-INDEPENDENCE (1947- 1991)

- At the time of independence, India was overwhelmingly rural inhabited by mostly illiterate people who were exceedingly poor. We had a deeply stratified society characterized by extreme heterogeneity on many counts. With the literacy rate just above 18 percent and barely 32 years of life expectancy in 1951, India's poverty was not just in terms of income alone, but also in terms of human capita.

- For historical reasons, the Nehruvian model which supported social and economic redistribution and industrialization directed by the state came to dominate the post-Independence Indian economic policy.
- Centralized economic planning and direction was at the core of India's development strategy and the economic policies were crafted to accomplish rapid economic growth accompanied by equity and distributive justice.

- The Planning Commission of India was established to meticulously plan for the economic development of the nation in line with the socialistic strategy. This was carried through the five-year plans which were developed, implemented and monitored by the Planning Commission.

- It is pertinent here to have a look at the ideology of industrialization prevailed in the early days of independence. India's political leadership was keen on establishing an economic system in which the central government would have authority to design the economic strategy and to carry out the necessary investments in coordination with the private sector.

- Rapid industrialization of the economy was the cornerstone of Nehru's development strategy. The concept of 'planned modernization' meant a systematic planning to support industrialization. The bureaucrats and the technocrats envisioned a substantially significant role for the state in industrialisation.

- The Industrial Policy Resolution (1948) envisaged an expanded role for the public sector and licensing to the private sector. It granted state monopoly for strategic areas such as atomic energy, arms and ammunition and railways. Also, the rights to new investments in basic Industries were exclusively given to the state.

- The policies in 1950's were guided by two economic philosophies:
1. The then prime minister Nehru's visualization to build a socialistic society with emphasis on heavy industry, and
2. The Gandhian philosophy of small scale and cottage industry and village republics

- The Industrial Policy Resolution of 1956 though provided a comprehensive framework for industrial development, was lopsided as its guiding principle supported enormous expansion of the scope of the public sector. A natural outcome of the undue priority for public sector was the dampening of private initiative and enterprise. For obvious reasons, private investments were discouraged and this had long-lasting negative consequences for industrial growth.

- India followed an open foreign investment policy and a relatively open trade policy until the late 1950s. A balance of payments crisis emerged in 1958 causing concerns regarding foreign exchange depletion. Consequently, there emerged a gradual tightening of trade and reduction in investment-licensing of new investments requiring imports of capital goods. The comprehensive import controls were maintained until 1966.

- In the first three decades after independence (1950-80), India's average annual rate of growth of GDP- often referred to as the 'Hindu growth rate'- was a modest 3.5 percent. While agriculture was not neglected, the thrust of the first decade and a half was on capital goods— capital-intensive projects such as dams, power plants, and heavy industrialization—rather than consumer goods.

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- The first major shift in Indian economic strategy was in the mid-1960s. Agriculture was not given adequate priority during the second plan and the outlays were reduced.
- The strategy for agricultural development till then was reliance on institutional model i.e. land reforms, farm cooperatives etc. and not much importance was given to technocratic areas such as research and development, irrigation etc.
- These institutional reforms were only modestly successful and the productivity increase in agriculture was meagre.

- With continuous failures of monsoon, two severe and consecutive droughts struck India in 1966 and 1967. The agricultural sector recorded substantial negative growth and India faced a serious food problem. India had to depend on the United States for food aid under PL 480.
- A quantum jump in the food grain production was the need of the hour. Increasing productivity in agriculture was given the highest priority. This, in fact, kick-started a strategic change in the government's agricultural policies. The new wave of change relied less on the earlier efforts at institutional change and relied more on enhancing productivity of agriculture, especially of wheat.
- A thorough restructuring of agricultural policy referred to as the 'green revolution' was initiated. The green revolution was materialised by innovative farm technologies, including high yielding seed varieties and intensive use of water, fertilizer and pesticides.
- The green revolution was successful in increasing agricultural productivity through technical progress and significantly increased food grain production enabling India to tide over the food problem.

- While India drastically changed its agricultural policies, the government introduced extra stringent administrative controls on both trade and industrial licensing and launched a wave of nationalization. The **government nationalized 14 banks in 1969** and then followed it up with **nationalizing another 6 in 1980**. The wide sweep of the interventionist policies that had come to exist in the 1960s had irreparable consequences in the next decade.

- The economic performance during the period of 1965-81 is the worst in independent India's history. The decline in growth during this period is attributed mainly to decline in productivity. The license-raj, the autarchic policies that dominated the 1960s and 1970s, the external shocks such as three wars (in 1962, 1965, and 1971), major droughts (especially 1966 and 1967), and the oil shocks of 1973 and 1979 contributed to the decelerated growth that lasted two decades. India being practically a closed economy missed out on the opportunities created by a rapidly growing world economy.

- Many government policies aimed at equitable distribution of income and wealth effectively killed the incentive for creating wealth. Equity driven policies were also largely anti growth. The Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 was aimed at regulation of large firms which had relatively large market power. Several restrictions were placed on them in terms of licensing, capacity addition, mergers and acquisitions. Thus, policies restricting the possibility of expansion of big business houses kept their entry away from nearly all but a few highly capital intensive sectors.

- In 1967, the policy of reservation of many products for exclusive manufacture by the small scale sector was initiated with the objective of promotion of small scale industries. It was argued that this policy will encourage labour-intensive economic growth and allow redistribution of income by shifting incomes towards lower wage earners.
- However, this policy excluded all big firms from labour intensive industries and India was not able to compete in the world market for these products. Stringent labour laws which were in place also discouraged starting of labour intensive industries in the organized sector.

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THE ERA OF REFORMS

- The seeds of early liberalisation and reforms were sown during the 1980s, especially after 1985. In early 1980s considerable efforts were initiated in different directions to restore reasonable price stability through a combination of tight monetary policy, fiscal moderation and a few structural reforms.
- These initiatives, spanning 1981 to 1989, practically referred to as 'early liberalization' were specifically aimed at changing the prevailing thrust on 'inward-oriented' trade and investment practices. In fact, this liberalization is often referred to as 'reforms by stealth' to denote its ad hoc and not widely publicized nature.
- Despite the fact that these efforts were not in the form of a comprehensive package (as the one in 1991) to reverse the centralised controls and the protectionist bias in policies, they started bearing fruits in the form of higher growth rate during the 1980s as compared with the previous three decades.
- The average annual growth rate of GDP during the sixth plan period (1980-1985) and the seventh plan period (1985-1990) were 5.7 and 5.8 percent respectively.

The early reforms of 1980's broadly covered three areas, namely industry, trade and taxation. Simultaneously, the government also embarked on a policy of skilful exchange rate management. The prominent industrial policy initiatives during this period directed towards removing constraints on growth and creating a more dynamic industrial environment were:

- In 1985 delicensing of 25 broad categories of industries was done. This was later extended to many others
- The facility of 'broad-banding' was accorded for industry groups to allow flexibility and rapid changes in their product mix without going in for fresh licensing. In other words, the firms in the engineering industry were allowed to change their product mix within their existing capacity. For example, firms may switch production between different production lines such as trucks and car without a new licence
- To relax the hold of the licensing and capacity constraints on larger MRTP firms, in 1985-86, the asset limit above which firms were subject to MRTP regulations was raised from 20 crore to 100 crore.
- The multipoint excise duties were converted into a modified value-added (MODVAT) tax which significantly reduced the taxation on inputs and the associated distortions.
- Establishment of the Securities and Exchange Board of India (SEBI) as a non-statutory body on April 12, 1988 through a resolution of the Government of India
- The open general licence (OGL) list was steadily expanded. The number of capital goods items included in the OGL list expanded steadily reaching 1,329 in April 1990.
- Several export incentives were introduced and expanded
- The exchange rate was set at a realistic level which helped expand exports and in turn reduced pressure on foreign exchange needed for imports
- Price and distribution controls on cement and aluminum were entirely abolished.
- Based on the real effective exchange rate (REER), the rupee was depreciated by about 30.0 per cent from 1985-86 to 1989-90. This reflects a considerable change in the official attitude towards exchange rate depreciation
- The budget for 1986 introduced policies of cutting taxes further, liberalising imports and reducing tariffs.

- However, the growth performance of the economy was thwarted due to structural inadequacies and distortions. The private sector investments were inhibited due to reasons such as convoluted licensing policies, public sector reservations and excessive government controls. Due to reservation of goods to small scale sector as well as excessive price and distribution controls, the private sector was virtually discouraged from making investments.
- The public sector which led the manufacturing and service sectors was plagued by inefficiency, government controls and bureaucratic procedures. Despite the fact that they were of massive in size and enjoyed monopoly in their respective areas, their performance was far from satisfactory and yielded very low returns on investment.

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- The MRTP act had many restrictive conditions creating barriers for entry, diversification and expansion for large industrial houses.
- Import controls in the form of tariffs, quotas and quantitative restrictions ensured that foreign manufactures and components did not cross the borders and compete with the domestic industries.
- Foreign investments and foreign competition were not allowed on grounds of affording protection to domestic industries.
- Briefly put, the rules and regulations which were aimed at promoting and regulating the economic activities became major hindrances to growth and development.

- Though the reforms in 1980's were limited in scope and were without a clearly observable road map as compared to the New Economic Policy in 1990, they were instrumental in bringing confidence in the minds of politicians and policy makers regarding the efficacy of policy changes to produce sustained economic growth.
- The belief that well-regulated competitive markets can ensure economic growth and also increase total welfare got fostered in the minds of policy makers.
- In other words, the idea that government intervention in markets need not always be accepted as 'the standard' and that markets should be given priority over government in the conduct of a good number of economic activities gained a broad acceptance.
- Thus, liberalization in the 1980s served as necessary foundation for the more universal and organized reforms of the 1990s.

THE ECONOMIC REFORMS OF 1991

India embarked on a bold set of economic reforms in 1991 under the Narsimha Rao government.

The causes attributed to the immediate need for such a drastic change are:

1. The fiscal initiatives for enhanced economic growth in 1980s saw the government revenue expenditure consistently exceeding revenue receipts. The fiscal deficit was financed by huge amounts of domestic as well as external debt. The high level current expenditure proved clearly unsustainable and got manifested on extremely large fiscal deficits and adverse balance of payments.
2. Persistent huge deficits led to swelling public debt and a large proportion of government revenues had to be earmarked for interest payments.
3. The surge in oil prices triggered by the gulf war in 1990 and the consequent severe strain on a balance of payments.
4. The foreign exchange reserves touched the lowest point with a reserve of only $1.2 billion which was barely sufficient for two weeks of imports. This was the major context that triggered economic reforms.
5. Tightening of import restrictions to muster forex for essential imports resulted in reduction in industrial output.
6. India had to depend on external borrowing from the International Monetary Fund which in turn put forth stringent conditions in terms of corrective policy measures before additional drawings could be made.
7. The fragile political situation along with the crises in the economic front ballooned into what may be called a 'crisis of confidence'.

- The year 1991 marked a paradigm shift in the Indian policy reforms. The nation which had embraced the 'socialist model', with the state playing an overriding role in the economy had the history of the government persistently intervening in the markets.
- Collapse of the Soviet Union and the spectacular success of China, based on outward oriented policies were lessons for the Indian policy makers. The reforms instituted in 1991 aimed to move the economy toward greater market orientation and external openness.

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- The reforms, popularly known as liberalization, privatization and globalisation, spelt a major shift in economic philosophy and fundamental change in approach and had two major objectives:

1. reorientation of the economy from a centrally directed and highly controlled one to a 'market friendly' or market oriented economy.
2. macroeconomic stabilization by substantial reduction in fiscal deficit.

- As we know, the momentum for reforms originated in the critical economic, fiscal and balance of payments crises. Therefore, the reform package was structured as a core package of mutually supportive reforms to address the balance of payment crisis and the structural rigidities.

- The policy paradigm focused on shifting from central direction to market orientation.

The policies can be broadly classified as :

1. stabilization measures which were short term measures to address the problems of inflation and adverse balance of payment and

2. the structural reform measures which are long term and of continuing nature aimed at bringing in productivity and competitiveness by removing the structural rigidities in different sectors of the economy.

Notes_____

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THE FISCAL REFORMS

The escalating deficit levels rendered the stabilisation efforts rather complicated. Bringing in fiscal discipline by reducing the fiscal deficit was vital because the crisis was caused by excess domestic demand, surge in imports and the widening of the current account deficit (CAD) which was to be financed by drawing down on reserves. This was attempted by radical measures to augment revenues and to curtail government expenditure. Measures to this effect included:

1. Introduction of a stable and transparent tax structure,
2. Ensuring better tax compliance,
3. Thrust on curbing government expenditure
4. Reduction in subsidies and abolition of unnecessary subsidies
5. Disinvestment of part of government's equity holdings in select public sector undertakings and
6. Encouraging private sector participation.

In order to bring in fiscal discipline, it was essential to do away with the temptation to finance deficit thorough the easy path of money creation. Therefore, the government entered into a historic agreement with the Reserve Bank in September 1994 to bring down the fiscal deficit in a phased manner to nil by 1997-98.

MONETARY AND FINANCIAL SECTOR REFORMS

Drastic monetary and financial sector reforms were introduced with the objective of making the financial system more efficient and transparent. The focus was mostly on reducing the burden of nonperforming assets on government banks, introducing and sustaining competition, and deregulating interest rates. These included many measures, important among them are:

1. Interest rate liberalization and reduction in controls on banks by the Reserve Bank of India in respect of interest rates chargeable on loans and payable on deposits.
2. Opening of new private sector banks and facilitating greater competition among public sector, private sector and foreign banks and simultaneously removal of administrative constraints that reduced efficiency.

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3. Reduction in reserve requirements namely, statutory liquidity ratio (SLR) and cash reserve ratio (CRR) in line with the recommendations of the Narasimham Committee Report, 1991.
4. Liberalisation of bank branch licensing policy and granting of freedom to banks in respect of opening, relocating or closure of branches
5. Prudential norms of accounting in respect of classification of assets, disclosure of income and provisions for bad debt were introduced in tune with the Narasimham Committee recommendations to ensure that the books of commercial banks reflect the accurate and truthful picture of their financial position.

REFORMS IN CAPITAL MARKETS

- The Securities and Exchange Board of India (SEBI) which was set up in 1988 was given statutory recognition in 1992. SEBI has been mandated as an independent regulator of the capital market so as to create a transparent environment which would facilitate mobilization of adequate resources and their efficient allocation.

THE 'NEW INDUSTRIAL POLICY'

- The 'New Industrial Policy' announced by the government on 24 July 1991 sought to substantially deregulate industry so as to promote growth of a more efficient and competitive industrial economy. In order to provide greater competitive stimulus to the domestic industry, a series of reforms were introduced

1. The New Economic Policy put an end to the 'License Raj' by removing licensing restrictions for all industries except for 18 that 'related to security and strategic concerns, social reasons, problems related to safety and overriding environmental issues'. Consequently, 80 percent of the industry was taken out of the licensing framework. This is subsequently reduced to 5, namely, arms and ammunition, atomic substances, narcotic drugs and hazardous chemicals, distillation and brewing of alcoholic drinks and cigarettes and cigars as these have severe implications on health, safety, and environment.
2. Public sector was limited to eight sectors based on security and strategic grounds. Subsequently only two items remained - railway transport and atomic energy
3. The Monopolies and Restrictive Trade Practices (MRTP) Act was restructured and the provisions relating to merger, amalgamation, and takeover were repealed. This has eliminated the need for pre-entry scrutiny of investment decisions and prior approval for large companies for capacity expansion or diversification.
4. Many goods produced by small-scale industries have been de reserved enabling entry of large scale industries.
5. The policy ended the public sector monopoly in many sectors. The number of areas reserved for public sector was narrowed down to ensure liberal participation by the private sector. Only eight industries which are of importance due to strategic and security concerns were reserved for the public sector. The changes continued and we find that now the industries reserved for the public sector are only a part of atomic energy generation and some core activities in railway transport.
6. Foreign investment was also liberalised. The concept of automatic approval was introduced for foreign direct investments up to 51 percent which was later extended to nearly all industries except the reserved ones. FDI is prohibited only in four sectors viz. retail trade, atomic energy, lottery business and betting and gambling.
7. External trade was further liberalised by substituting 'the positive list approach' of listing license-free items on the OGL list with the negative list approach. The policy did away with import licensing on all but a handful of intermediate and capital goods. The consumer goods which remained under licensing was made free 10 years later. Today, except for a handful of goods disallowed on health, environmental and safety grounds, and few others such as edible oil, fertilizer and petroleum products all goods can be imported.
8. In 1990-91, the highest tariff rate was 355%, The top tariff rate was brought down to 85% in 1993-94 and to 50% in 1995-96 and by 2007-08, it has come down to 10% with some exceptions such as automobile at 100%
9. Rupee was devalued by 18% against the dollar. From 1994 onwards, all current account transactions including business, education, medical and foreign travel were permitted at market exchange rate and rupee became officially convertible on current account

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10. The disinvestment of government holdings of equity share capital of public sector enterprises was a very bold step. The hitherto constrained and opportunity for professional management for ensuring reasonable returns. The budgetary support to public sector was progressively reduced.

TRADE POLICY REFORMS

The trade policy reforms aimed at:

- dismantling of quantitative restrictions on imports and exports
- focusing on a more outward oriented regime with phased reduction and simplification of tariffs, and
- removal of licensing procedures for imports.

A number of export incentives were continued and new ones were initiated for boosting exports. Export duties were removed to increase the competitive position of Indian goods in the international markets. In 1991, India still had a fixed exchange rate system, under which the rupee was pegged to the value of a basket of currencies of major trading partners.

In July 1991 the Indian government devalued the rupee by between 18 and 19 percent. In March 1992 the government decided to establish a dual exchange rate regime. The government allowed importers to pay for some imports with foreign exchange valued at free-market rates and other imports could be purchased with foreign exchange purchased at a government - mandated rate. In March 1993 the government unified the exchange rate and allowed, for the first time, the rupee to float. From 1993 onwards, India has followed a managed floating exchange rate system.

India has witnessed vast changes over the last 31 years of economic reforms. Changes enumerated below are only broad observations and are in no way comprehensive.

- India has increasingly integrated its economy with the global economy.
- India has progressively moved towards a market oriented economy, with a sizeable reduction in government's market intervention and controls
- There is an unprecedented growth of private sector investment and initiatives
- A number of sectors such as auto components, telecommunications, software, pharmaceuticals, biotechnology, and professional services have achieved vey high levels of international competitiveness
- Easing of trade controls has enabled easier access to foreign technology, inputs, know-how and finance
- Stable foreign direct investment inflows and substantial foreign portfolio investments
- India enjoys a solid cushion of foreign exchange reserves close to eight months of import cover. India has one of the largest holdings of international reserves in the world.
- Robust demand for information technology and financial services has kept the services trade surplus high at around 3.7 percent of GDP
- Pressure on the Indian rupee is lower compared to other emerging market economies (EMEs)
- Increased incomes, large domestic market and high levels of aggregate demand sustains the economy.
- India is better placed than most of the emerging market economies to deal with global headwinds
- Poverty has reduced substantially
- Reforms led to increased competition in sectors like banking, insurance and other financial services leading to greater customer choice and increased efficiency. It has also led to increased investment and growth of private players in these sectors.
- Infrastructure sectors have achieved phenomenal growth
- Value-added share of agriculture and allied activities has declined steadily over the past four decades.
- India's financial sector has also deepened considerably due to increased financial sector liberalisation.

However, the country is constrained by high levels of fiscal deficit, inflation and a high level of debt as a share of GDP at 86 percent of GDP in FY21/22. Among the emerging market and developing economies (EMDEs), India's debt is higher than their average of 64.5% for 2022 (IMF).

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GDP GROWTH RATES POST 1991 REFORMS

➢ As we are aware, GDP growth rate is regarded as the most reliable indicator of economic growth. The following table and graphical presentation present data on GDP growth rate post 1991 reforms.

GDP Growth (Annual %) – India from 1991 to 2021

Year	GDP Growth (Annual %)	Year	GDP Growth (Annual %)
1991	1.056831	2006	8.060733
1992	5.482396	2007	7.660815
1993	4.750776	2008	3.086698
1994	6.658924	2009	7.861889
1995	7.574492	2010	8.497585
1996	7.549522	2011	5.241315
1997	4.049821	2012	5.456389
1998	6.184416	2013	6.386106
1999	8.845756	2014	7.410228
2000	3.840991	2015	7.996254
2001	4.823966	2016	8.256306
2002	3.803975	2017	6.795383
2003	7.860381	2018	6.453851
2004	7.922937	2019	3.737919
2005	7.923431	2020	6.59608
		2021	8.681229

GDP Growth (Annual %) – India from 1991 to 2021



NITI AAYOG: A BOLD STEP FOR TRANSFORMING INDIA

➢ For nearly sixty four years, the Planning Commission of India - a powerful advocate of public investment-led development - was one of the most important institutions within India's central government.

➢ The new ideologies of the neoliberal era with their centre of attention on market orientation and shrinking roles of the government and the collapse of the planning system called for a change in the nature, composition and scope of institutions of governance.

➢ On 1st January 2015, the apex policy-making body namely Planning Commission, was replaced by the National Institution for Transforming India (NITI) Aayog.

➢ The major objective of such a move was to 'spur innovative thinking by objective 'experts' and promote 'co-operative federalism' by enhancing the voice and influence of the states'. NITI Aayog is expected to serve as a 'Think Tank' of the government. [and] a 'directional and policy dynamo'.

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➢ NITI Ayog will work towards the following **objectives***:

1. To evolve a shared vision of national development priorities, sectors and strategies with the active involvement of states.
2. To foster cooperative federalism through structured support initiatives and mechanisms with the states on a continuous basis, recognizing that strong states make a strong nation.
3. To develop mechanisms to formulate credible plans at the village level and aggregate these progressively at higher levels of government.
4. To ensure, on areas that are specifically referred to it, that interests of national security are incorporated in economic strategy and policy.
5. To pay special attention to the sections of our society that may be at risk of not benefiting adequately from economic progress.
6. To design strategic and long-term policy and programme frameworks and initiatives, and monitor their progress and their efficacy
7. To provide advice and encourage partnerships between key stakeholders and national and international like-minded think tanks, as well as educational and policy research institutions.
8. To create a knowledge, innovation and entrepreneurial support system through a collaborative community of national and international experts, practitioners and other partners.
9. To offer a platform for the resolution of inter-sectoral and inter departmental issues in order to accelerate the implementation of the development agenda.
10. To maintain a state-of-the-art resource centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stake-holders.
11. To actively monitor and evaluate the implementation of programmes and initiatives, including the identification of the needed resources so as to strengthen the probability of success and scope of delivery.
12. To focus on technology up gradation and capacity building for implementation of programmes and initiatives.
13. To undertake other activities as may be necessary in order to further the execution of national development agenda, and objectives mentioned above. *NITI Aaayog https://niti.gov.in/objectives-and-features

➢ **The key initiatives of NITI Aayog are:**

1. 'Life' which envisions replacing the prevalent 'use-and-dispose' economy
2. The National Data and Analytics Platform (NDAP) facilitates and improves access to Indian government data
3. Shoonya campaign aims to improve air quality in India by accelerating the deployment of electric vehicles
4. E-Amrit is a one-stop destination for all information on electric vehicles
5. India Policy Insights (IPI)
6. 'Methanol Economy' programme is aimed at reducing India's oil import bill, greenhouse gas (GHG) emissions, and converting coal reserves and municipal solid waste into methanol, and
7. 'Transforming India's Gold Market' constituted by NITI Aayog to recommend measures for tapping into the potential of the sector and provide a stimulus to exports and economic growth.

There are arguments put forth by experts about the weaknesses of the system. They argue that NITI has a limited role; it does not produce national plans, control expenditures, or review state plans. The major shortcoming of NITI is its exclusion from the budgeting process. It also lacks autonomy and balance of power within policy making apparatus of the central government. The termination of the Planning Commission has strengthened the hand of the Ministry of Finance, with its 'fixation on near-term macroeconomic stability and the natural instinct to limit expenditure'. But NITI lacks the independence and power to perform as a 'counterweight' to act as a "voice of development" concerned with inequities.

THE CURRENT STATE OF THE INDIAN ECONOMY: A BRIEF OVERVIEW

On account of the enormity of the economic phenomena and the dynamic nature of economic variables, it is not possible to have an up-to-date and comprehensive documentation on the current state of the economy.

Given the constraints of the unit, an attempt is made in the following sections to present the broad nature of the present day Indian economy based on the three sectors namely, primary, secondary and tertiary.

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THE PRIMARY SECTOR

- Agriculture, with its allied sectors, is indisputably the largest source of livelihood in India. Till the end of 1960's, India was a food deficient nation and depended on imports.
- India has emerged as the world's largest producer of milk, pulses, jute and spices. India has the largest area planted under wheat, rice and cotton.
- It is the second-largest producer of fruits, vegetables, tea, farmed fish, cotton, sugarcane, wheat, rice, cotton, and sugar.
- Indian food and grocery market is the world's sixth largest, with retail contributing 70% of the sales. India has the world's largest cattle herd (buffaloes).The Indian livestock sector attained a record growth of 6.6 per cent during the last decade (2010-19) emerging as a major producer of milk, egg and meat in the world.
- India grows large varieties of cash crops of which cotton, jute and sugarcane are prominent. Although the share of agriculture has been declining in overall gross value added (GVA) of India, it continues to grow in absolute terms.

According to the latest estimates, 47 per cent of India's population is directly dependent on agriculture for living. It also contributes a significant figure to the Gross Domestic Product (GDP). Gross Value Added by the agriculture and allied sector was 18.8% in 2021-22 (until 31 January, 2022).

The index numbers of agricultural production in 2021-22 (base: triennium ending 2007- 08=100) for categories namely, all crops, food-grains, cereals, wheat and coarse cereals was above 140; and that of rice and pulses was 138.7 and 196.2 respectively. For non- food grains, it was 142.9. These figures show sustained increase in agricultural output. Food grains production has reached 315.7 million tonnes in 2021-22. Private investment in agriculture has increased to 9.3% in 2020-21. (Source: Handbook of Statistics on the Indian Economy, 2021-22)

As per the economic survey, 2022-23, agriculture remained robust, recording a growth of 3.5 per cent in 2022-23, driven by buoyant rabi sowing and allied activities. The performance of the agriculture and allied sectors has been buoyant over the past several years, much of which is on account of the measures taken by the government to:

- augment crop and livestock productivity,
- ensure certainty of returns to the farmers through price support (The Minimum Support Price (MSP) of all 23 mandated crops is fixed at 1.5 times of all India weighted average cost of production)
- promote crop diversification,
- improve market infrastructure through the impetus provided for the setting up of farmer-producer organisations and
- promotion of investment in infrastructure facilities through the Agriculture Infrastructure Fund.

India has achieved a remarkable shift from a food deficient and import dependent nation during the early nineteen sixties to a food exporting nation. India is among the top ten exporters of agricultural products in the world. Export of agricultural and allied products has witnessed significant increase during the last few years and touched an all-time peak of Rs 374611 crore during the last one year. Exports of agricultural and processed food products rose by 25 percent within six months of the current financial year 2022-23 (April-September) in comparison to the corresponding period in 2021-22. Agricultural and Processed Food Export Development Authority (APEDA) is entrusted with the responsibility of export promotion of agri-products.

- A number of liberalization measures are adopted by the government. The Government of India has allowed 100% FDI in marketing of food products and in food product E-commerce under the automatic route. Considering the diverse needs of the agricultural sector and the larger farming community, a large number of interventions are undertaken by different governments.
- A few such recent measures are:

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- Income support to farmers through PM KISAN
- Fixing of Minimum Support Price (MSP) at one-and-a half times the cost of production
- Institutional credit for agriculture sector at concessional rates
- Launch of the National Mission for Edible Oils • Pradhan Mantri Fasal BimaYojana (PMFBY) – a novel insurance scheme for financial support to farmers suffering crop loss/damage
- Mission for Integrated Development of Horticulture (MIDH) for the holistic growth of the horticulture sector
- Provision of Soil Health Cards
- Paramparagat Krishi Vikas Yojana (PKVY) supporting and promoting organic farming, and improvement of soil health.
- Agri Infrastructure Fund, a medium / long term debt financing facility for investment in viable projects for post-harvest management Infrastructure and community farming assets
- Promotion of Farmer Producer Organisations (FPOs) to ensure better income for the producers through an organization of their own.
- Per Drop More Crop (PDMC) scheme to increase water use efficiency at the farm level
- Setting up of Micro Irrigation Fund
- Initiatives towards agricultural mechanization
- Setting up of E-NAM -a pan-India electronic trading portal which networks the existing APMC mandis to create a unified national market for agricultural commodities.
- Introduction of Kisan Rail for improvement in farm produce logistics, and
- Creation of a Start-up Eco system in agriculture and allied sectors

Despite phenomenal increase in output of both food crops and commercial crops, Indian agriculture faces many issues such as:

- Indian agriculture is dominated by small and medium farmers. Small and fragmented landholdings, low farm productivity and subsistence farming result in very little marketable surplus and the consequent lower income levels of the agriculturists. These also reduce their ability to participate in the domestic as well as export market.
- Indian agriculture is resource intensive, cereal centric and regionally biased. There is Increasing stress on water resources and soil fertility. Unscientific and wasteful agricultural practices lead to desertification and land degradation in many parts of the country.
- Inadequate agro-processing infrastructure and failure to build competitive value chains from producers to urban centers and export markets • Sluggish agricultural diversification to higher-value commodities
- Inadequate adoption of environmentally sustainable and climate resistant new farm technology
- Poor adoption of new agricultural technologies
- Lopsided marketing practices and ineffective credit delivery
- Complexities associated with adaptation to climate change disturbances
- High food price volatility
- Heavy dependence on monsoons and loss of crops and livelihood due to vagaries of nature
- Issues related to marketing and warehousing of agricultural products
- Inability to tap the full export potential of primary as well as value added products
- Inability to effectively channelize huge surpluses in some commodities to alternative profitable destinations
- Inadequate post-harvest infrastructure and management practices
- Incidence of poverty and malnutrition

THE SECONDARY SECTOR

- The Indian industry holds a significant position in the Indian economy contributing about 30 percent of total gross value added in the country and employing over 12.1 crores of people. The industrial sector in India broadly comprises of manufacturing, heavy industries, fertilizers, pharmaceuticals, chemicals and petrochemicals, oil and natural gas, food processing, mining, defence products, textiles, retail, micro, small & medium enterprises, cottage industries and tourism.
- The share of informal sector in the economy is more than 50% of GVA. Rapid industrial growth of domestic industries and diversification of industrial structure are essential elements for sustainable economic growth. The development of a robust manufacturing sector is a key priority of the Indian Government.

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- In India, industrial production measures the output of businesses integrated in industrial sector of the economy.
- Manufacturing is the most important sector and accounts for 78 percent of total production. The manufacturing GVA at current prices was estimated at US$ 77.47 billion in the third quarter of financial year 2021-22 and has contributed around 16.3% to the nominal GVA during the past ten years.
- In 2022- 23 (until September 2022), the combined index of eight core industries* stood at 142.8 driven by the production of coal, refinery products, fertilizers, steel, electricity and cement industries.
- In Jan 31, 2023 the Manufacturing Purchasing Managers' Index (PMI) in India stood at 55.4. India's rank in the Global Innovation Index (GII) improved to 40th in 2022 from 81st in 2015.

The Department for Promotion of Industry and Internal Trade (DPIIT) has a role in the formulation and implementation of industrial policy and strategies for industrial development in conformity with the development needs and national objectives.

Ever since independence, many innovative schemes are undertaken by different governments from time to time to boost industrial performance.

Some of the policies are presented below:

- Introduction of goods and services tax (GST) on 1 July 2017 as a single domestic indirect tax law for the entire country replacing many indirect taxes in India such as the excise duty, VAT, services tax, etc.
- Reduction of corporate tax to domestic companies giving an option to pay income-tax at the rate of 22% subject to condition that they will not avail any exemption/incentive.
- **'Make in India' is a 'Vocal for Local'** initiative launched in 2014 to facilitate investment, foster innovation, build excellent infrastructure and make India a hub for manufacturing, design and innovation. Make in India 2.0' is now focusing on 27 sectors, which include 15 manufacturing sectors and 12 service sectors.
- 'Ease of Doing Business' with key focus areas as simplification of procedures, rationalization of legal provisions, digitization of government processes, and decriminalization of minor, technical or procedural defaults. India ranks 63rd in the World Bank's annual Doing Business Report (DBR), 2020 as against 77th rank in 2019 registering a jump of 14 ranks.
- **The National Single Window System** is a one-stop-shop for investor related approvals and services in the country and aims to provide continuous facilitation and support to investors.
- **PM Gati Shakti National Master Plan** to facilitate data-based decisions related to integrated planning of multimodal infrastructure, thereby reducing logistics cost.
- **National Logistics Policy (NLP)** launched in September 2022, aims to lower the cost of logistics and make it at par with other developed countries.
- Keeping in view India's vision of becoming 'Atmanirbhar', the Production Linked Incentive (PLI) Scheme was initiated in March 2020 for 14 key sectors to enhance India's manufacturing capabilities and export competitiveness. PLI Scheme is now extended for white goods (air conditioners and led lights).
- **Industrial Corridor Development Programme:** Greenfield Industrial regions/areas/nodes with sustainable infrastructure and to make available 'plug and play' infrastructure at the plot level.
- **FAME-India Scheme** (Faster Adoption and Manufacturing of Hybrid and Electric Vehicles) to promote manufacturing of electric and hybrid vehicle technology and to ensure sustainable growth of the same.
- **'Udyami Bharat'** aims at the empowerment of Micro Small and Medium Enterprises (MSMEs).
- **PM Mega Integrated Textile Region and Apparel** (PM MITRA): to ensure world-class industrial infrastructure which would attract cutting age technology and boost FDI and local investment in the textiles sector.
- **Opening up for global investments:** To make India a more attractive investment destination, the government has implemented several radical and transformative FDI reforms across sectors such as defence, pension, e-commerce activities etc.

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- **100 per cent FDI under automatic route** is permitted for the sale of coal, and coal mining activities, including associated processing infrastructure and for insurance intermediaries.
- **Foreign Investment Promotion Board (FIPB)** was abolished in May 2017, and a **new regime** namely **Foreign Investment Facilitation Portal (FIF)** has been put in place. Under the new regime, the process for granting FDI approvals has been simplified. **853 FDI proposals were disposed off in the last 5 years. FDI has increased jumped by 39% since FIF** came into being.
- **Remission of Duties and Taxes on Export Products (RoDTEP) 2021 formed to replace the existing MEIS** (Merchandise Exports from India Scheme) to boost exports. It provides for rebate of all hidden central, state, and local duties/taxes/levies on the goods exported which have not been refunded under any other existing scheme.
- Initiatives towards fostering innovation include incubation, handholding, funding, industry-academia partnership and mentorship and strengthening of IPR regime.
- **National Logistics Policy (NLP)** is **comprehensive policy framework** for the **Logistics Sector**.
- **Start-up India Programme** acts as the facilitator for ideas and innovation in the country. **India's rank** in the **Global Innovation Index** (GII) has improved from **81st in 2015 to 40th in 2022**.
- **Public Procurement (Preference to Make in India) Order, 2017** gives preference to locally manufactured goods, works and services in public procurement thereby giving boost to industrial growth.
- **The Emergency Credit Line Guarantee Scheme (ECLGS)** is a fully guaranteed emergency credit line to monitor lending institutions.

India is gearing up for the **fourth industrial revolution** or **Industry 4.0** in which manufacturing transformation needs to integrate new technologies such as **cloud computing, IoT, machine learning, and artificial intelligence (AI)**. The National Manufacturing Policy which aims to **increase the share of manufacturing in GDP to 25 percent by 2025** is a step in this direction.

India is an attractive hub for foreign investments in the manufacturing sector. Over the last few years, FDI equity inflows in the manufacturing sector have been progressively rising. India continues to open up its sectors to global investors by raising FDI limits and removing regulatory barriers in addition to developing infrastructure and improving the business environment. According to the Department for Promotion of Industry and Internal Trade (DPIIT), India received a total **foreign direct investment (FDI) inflow of US$ 58.77 billion in 2021-22**.

There are many challenges to the industrial sector; a few of these are enumerated below:

- **Shortage of efficient infrastructure** and **manpower** and consequent reduced factor productivity.
- **Reliance on imports, exchange rate volatility** and **associated time** and **cost overruns**
- **The MSME sector is relatively less favorably placed** in terms of credit availability.
- **Industrial locations established without reference to cost-effective points** tend to experience unsustainable cost structure.
- **Heavy losses, inefficiencies, lower productivity** and **unsustainable returns** plaguing public sector industries.
- **Strained labor-management relations** and **loss of man hours.**
- **Lower export competitiveness, slowing external demand** and **imposition** of **non tariff barriers** by other countries.
- **Global supply chain disruptions** and **uncertainties.**
- **Inflation and associated macro economic developments** leading to input cost escalations and lower demand.
- Global slowdown and related negative sentiments affecting investment.
- **Aggressive tightening of monetary policy and increases in cost of credit.**
- **High and increasing fuel prices**, and
- **Mounting presence of informal sector.**

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THE TERTIARY SECTOR

A remarkable feature of the **post reform Indian economy** is the **overarching role of the services sector** in generating growth of income and employment. Unlike the usual economic development process of nations where **economic growth has led to a shift from agriculture to industries**, or from the **primary sector to the secondary sector**, India has the unique experience of **bypassing the secondary sector** in the growth trajectory by a **shift from agriculture to the services sector**.

India's services sector covers wide variety of activities. (Refer Box 2)

	BOX 2. The broad classification of services as per the National Industrial Classification, 2008
1.	Wholesale and retail trade and repair of vehicles
2.	Transportation and storage
3.	Accommodation and food service activities
4.	Information and communication
5.	Financial and insurance activities
6.	Real estate activities
7.	Professional, scientific and technical activities
8.	Administrative and support services
9.	Public administration, defence and compulsory social security
10.	Education
11.	Human health and social work activities
12.	Arts, entertainments and recreation
13.	Other service activities
14.	Activities of households as employers, undifferentiated goods and services producing activities of households for own use
15.	Activities of extra territorial organizations and bodies

- The **service sector** refers to **industry producing intangible goods** viz. services as output. The services sector is the largest sector of India & accounts for 53.89% of total India's GVA. The Gross Value Added (GVA) at current prices for the services sector is estimated at ₹ 96.54 lakh crore in 2020-21.
- The service sector is the fastest growing sector in India and has the highest labour productivity. Both domestic and global factors influence the growth of the services sector. The exceptionally rapid expansion of knowledge-based services such as professional and technical services has been responsible for the faster growth of the services sector.
- The production and consumption of **information-intensive service activities** such as **computing**, **accounting**, **inventory management**, **quality control**, **personnel administration**, **marketing**, **advertising** and **legal services** has increased manifold due to application of **state- of the- art information technology**.
- Services sector growth can also complement growth in the manufacturing sector. The start-ups which have grown remarkably over the last few years mostly belong to the services sector.

- **India is among the top 10 World Trade Organization** (WTO) members in service exports and imports. India's services exports at US$ 27.0 billion recorded robust growth in November 2022 due to software, business, and travel services.
- While exports from all other sectors were adversely affected, India's services exports have remained resilient during the Covid-19 pandemic. The reasons are the higher demand for digital support and need for digital infrastructure modernization.
- The Indian services sector is the **largest recipient of FDI inflows**. FDI equity inflows into the services sector accounted for more than 60 per cent of the total FDI equity inflows into India.
- The **World Investment Report 2022 of UNCTAD** places **India** as the **seventh largest recipient of FDI in the top 20 host countries in 2021**. In 2021-22, India received the **highest-ever FDI inflows of US$ 84.8 billion** including US$ 7.1 billion FDI equity inflows in the services sector.

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- To ensure the liberalisation of investment in various industries, the government has permitted 100 per cent foreign participation in telecommunication services through the Automatic Route including all services and infrastructure providers.
- The FDI ceiling in insurance companies was also raised from 49 to 74 per cent.
- Measures undertaken by the Government, such as the launch of the National Single-Window system and enhancement in the FDI ceiling through the automatic route, have played a significant role in facilitating investment.

CONCLUSION

- The India Development Update (IDU) of the World Bank published in November 2022, observes that India had to face an unusually challenging external environment following the Russia-Ukraine war, increased crude oil and commodity prices, persistent global supply disruptions, tighter financial conditions and high domestic inflationary pressures.
- Despite all these, the real GDP of India grew by 6.3 percent in July-September of 2022-23 driven by strong private consumption and investment.
- The report observes that India's economy is relatively more insulated from global spillovers than other emerging markets and is less exposed to international trade flows on account of reliance on its large domestic market.
- As such, compared to other emerging economies, India is much more resilient to withstand adversities in the global arena.

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