

'macro-economic analysis for rural society'

[Economics](#), [Tax](#)



' Macro-Economic Analysis for Rural Society' Assignment on: PROBLEMS AND PROSPECTS OF DIRECT TAXATION IN INDIA By Manu Bansal (U311024)

PGDM-RM-I-2011 Submitted to Prof. Sureswari Prasad Das Xavier Institute of Management, Bhubaneswar INTRODUCTION TO DIRECT TAXATION:-

----- General meaning In the general sense, a direct tax is one paid directly to the government by the persons (juristic or natural) on whom it is imposed (often accompanied by a tax return filed by the taxpayer). Examples include some income taxes, some corporate taxes, and transfer taxes such as estate (inheritance) tax and gift tax. In this sense, a direct tax is contrasted with an indirect tax or "collected" tax (such as sales tax or value added tax (VAT)); a "collected" tax is one which is collected by intermediaries who turn over the proceeds to the government and file the related tax return. Some commentators have argued that "a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be." An 18th century writing about the tax explained: | "The power of direct taxation applies to every individual, as congress under this government is expressly vested with the authority of laying a capitation or poll-tax upon every person to any amount. This is a tax that, however oppressive in its nature, and unequal in its operation, is certain as to its produce and simple in its collection; it cannot be evaded like the objects of imposts or excise, and will be paid, because all that a man hath will he give for his head. This tax is so congenial to the nature of despotism, that it has ever been a favorite under such governments. Some of those who were in the late general convention from this state, have long labored to introduce a poll-tax among us. The power of

direct taxation will further apply to every individual, as congress may tax land, cattle, trades, occupations, &c. to any amount, and every object of internal taxation is of that nature, that however oppressive, the people will have but this alternative, either to pay the tax, or let their property be taken for all resistance will be vain. The standing army and select militia would enforce the collection. "Direct Taxation in India Direct taxation in India is taken care by the Central Board of Direct Taxes (CBDT); it is a division of Department of revenue under Ministry of Finance. CBDT is governed by the revenue act 1963. CBDT is given the authority to create and control direct taxes in India. The most important function of CBDT is to manage direct tax law followed by Income Tax department. In India the tax structure is divided amongst the central government and state government. The central government levies taxes on income, custom duties, central excise and service tax. While the state government levies tax like state excise, stamp duty, VAT (Value Added Tax), land revenue and professional tax. Local civic bodies levy tax on properties, octroi etc. Capital gains tax, personal income tax, tax on corporate income and tax incentives all come under the purview of direct tax. Direct taxes are charged on the basis of residential status and not on the basis of citizenship. The assessee are charged based upon the following factors * Resident * Resident but not ordinary resident. * Nonresident. Direct Taxes Before Reform:- They had a major impact on economic policies, creation of savings and the trend of investment. There was no proportion in terms of the impact of direct taxes on the economy and there relative share in total tax revenues. The system of direct taxes was very much complex and inefficient because of the combination of high

marginal rates of personal income and wealth taxation and high rates of corporate profits. The corporate tax was pretty high. It leads to large scale evasion. Members Of Parliament and Central Government Ministers get comparatively low salaries, but they are given a sitting allowance which is not taxable. Ministers, MP's and other high ranking government officials get government allocated accommodation, where the charges are pretty less in comparison to the prevailing market rate.

Growth in Direct Tax collection during the Financial Year 2008-09:- Net direct tax collection during the fiscal 2008-09 stands at Rs. 338, 212 crore, up from Rs. 312, 202 crore during 2007-08, registering a growth of 8. 33 percent. Growth in Corporate Taxes was 10. 84 per cent, while Personal Income Tax (including FBT, STT and BCTT) grew at 9. 09%. Despite economic slow-down and substantial relief to non-corporate taxpayers, direct tax collections exceeded the previous year's collection by about Rs. 26, 000 crore.

Growth In Direct Tax Collection During The Financial Year 2009-2010:- The net direct tax collections grew by 5. 77 per cent during the first two months of the current fiscal (2009-2010). It was Rs 24, 158 crore compared to Rs 22, 840 crore at the same time last year. Corporate tax grew at 5. 56 per cent (Rs 8578 crore against Rs 8126 crore), while personal income tax (including FBT, STT and BCTT) grew at 5. 92 per cent (Rs 15, 559 crore as against Rs 14, 690 crore). Overall refund outgo during the period increased by 26. 19 per cent (Rs 11, 375 crore as against Rs 9014 crore) while refunds to non corporate taxpayers grew by 61. 7 per cent (Rs 2, 149 crore against Rs 1, 329 crore).

| DIRECT TAX REFORMS IN INDIA An article from the daily ' Deccan Herald' describes Direct Tax Code as follows:-The proposed Direct Tax Code is a combination of major tax relief

and removal of most tax-exempted benefits. It is expected to usher in a new tax regime of transparency and greater compliance writes Dilip Maitra. | | |

When archaic rules have to be replaced with new ones, the changes must be dramatic and path breaking. This is what Union Finance Minister Pranab Mukherjee conveyed to all taxpayers when he introduced the draft Direct Tax Code (Tax Code) . The Tax Code, now open to public debate, will be introduced as a Bill in Parliament's winter session. If passed, it will become the new Income Tax Act, replacing the existing four decade old IT Act of 1961. The new IT Act will come into force from April 1, 2012. In the foreward to the Tax Code Mukherjee explains that the aim is to eliminate distortions in the tax structure, introduce moderate levels of taxation, expand the tax base, improve tax compliance, simplify the language and lower tax litigations. Initial analysis shows that most of these objectives are achievable by tweaking of some provisions. Talking to Deccan Herald, KPMG Executive Director Personal Taxation, IT & ESOP Vikas Vasal said " The new proposals are in the right direction. They will simplify regulations and reduce unnecessary litigations significantly. " Agreed Bangalore Chamber of Industry & Commerce (BCIC) President K R Girish. " The Code is a completely new law and not an amendment of the existing Income Tax Act. This is a commendable change as one has always experienced tinkering of existing laws, " observes Girish. | One of the well known benefits of direct taxes is that they can act as automatic stabilizers. Progressive personal income taxes tend to withdraw proportionally more private income during economic expansions and less so during contractions of the economy. Similarly, corporate income taxes yield higher revenues when profits are high in the

expansion phase of the business cycle but they drop considerably in the contraction phase. On the other hand, the indirect taxes such as VAT or excises lack this stabilizing feature.

Advantages / Merits of Direct Taxes

Following are the important advantages or merits of Direct Taxes :-

- 1. Equity**
There is social justice in the allocation of tax burden in case of direct taxes as they are based on the principle of ability to pay. Persons in a similar economic situation are taxed at the same rate. Persons with different economic standing are taxed at a different rate. Hence, there is both horizontal and vertical equity under direct taxation. Progressive direct taxation can reduce income inequalities and bring about adequate social & economic justice. For example, in the Indian Budget of 2007, individual with an income of upto Rs. 1, 10, 000 are exempted from payment of income tax and in the case of women tax payer, the exemption limit is Rs. 1, 45, 000.
- 2. Certainty**
As far as direct taxes are concerned, the tax payer is certain as to how much he is expected to pay, as the tax rates are decided in advance. The Government can also estimate the tax revenue from direct taxes with a fair accuracy. Accordingly, the Government can make adjustments in its income and expenditure.
- 3. Relatively Elastic**
The direct taxes are relatively elastic. With an increase in income and wealth of individuals and companies, the yield from direct taxes will also increase. Elasticity also implies that the government's revenue can be increased by raising the rates of taxation. An increase in tax rates would increase the tax revenue.
- 4. Creates Public Consciousness**
They have educative value. In the case of direct taxes, the taxpayers are made to feel directly the burden of taxes and hence take keen interest in how public funds are spent. The taxpayers are likely to be more

aware about their rights and responsibilities as citizens of the state. 5.

Economical Direct taxes are generally economical to collect. For instances, in the case of personal income tax, the tax can be deducted at source from the income or salaries of the individuals. Therefore, the government does not have to spend much in tax collection as far as personal income tax is concerned. However, in the case of indirect taxes, the government has to set up an elaborate machinery to collect taxes. 6. Anti-inflationary The direct taxes can help to control inflation. During inflationary periods, the government may increase the tax rate. With an increase in tax rate, the consumption demand may decline, which in turn may reduce inflation. The study of J. Ram Pillarisetti, Deakin University, Victoria, Australia Argues that direct tax reform in India should include elimination of income tax and capital gains taxes. Presents an analysis of how the unbelievably high direct tax rates over several years, coupled with several types of controls, drastically distorted the price and incentive system. Shows that, in comparison with several other developing countries, India is still a high taxed economy. The institutionalized corruption resulting from these direct taxes over several years cannot be reduced without elimination of these taxes, and measures such as broadening of direct tax base, higher penalties, etc. are counter-productive. The official national accounts statistics in such a high tax regime do not reflect the economy, and the government policy and planning based on these statistics often proved ineffective. The success of liberalization programmes, environmental conservation, and general socio-economic development requires the elimination of these taxes. During the 1980s, there has been substantial tax reform across many developing

countries (Ahmad and Stern, 1991; Bagchi, 1991; Bird, 1987; Khalilzadeh-Shirazi and Shah, 1991; Shome, 1992; Slemrod, 1990; Tanzi and Shome, 1993; and Thrisk, 1990). India has embarked on several economic reforms including privatization, floating of the rupee, removal of several licensing procedures and controls on several sectors and foreign investments, streamlining the administrative mechanism etc. (for a theoretical discussion on privatization and tax pressure see Bos (1991)). These measures have undoubtedly improved the economic climate, but it should be noted that several of the distortions created over the years appear almost irreversible at this stage due to the emergence of a large number of "rent seekers" (Dougan, 1991; Murphy et al., 1993). A recent move to denationalize several government enterprises and banks met strong resistance from labour unions. The opposition to privatization from different political groups appears to put a break on the liberalization process. In this article we analyse the issues relating to reform of direct taxes in India in the light of recent economic liberalization and compare the scenario with the tax reform and liberalization episodes of selected Latin American countries. The Indian economy has been subjected to substantial and unique policy induced distortions since independence in 1947. The regulatory system in India controls almost all aspects of the economy. The entry and growth of firms is controlled by capacity licensing, monopoly control, foreign investment and technology import control, and the reservation of products for small-scale industry. This small-scale reservation policy proved detrimental to the industrial base as about 863 products are now reserved for the small-scale industry (SSI) sector and the existing firms above the guidelines are not

given licences to expand. Thus internal competition is reduced and a heavy price is paid in several product lines in terms of quality, costs, and technology (World Bank, 1989). On the financial sector, major financial institutions including major banks are government owned reflecting inefficient performance and over-staffing. The property rights are improperly enforced with the right to property being removed from the list of the Fundamental Rights in the Constitution of India, and the tenancy and other related legislation are archaic. It is against this backdrop that we examine the direct tax reform. The purpose of the article is to examine the nature and direction of Indian direct tax reform and comment on the direct tax structure that will reduce distortions and rent seeking, and enable the economy to take full advantage of the liberalization efforts. The primary purpose of the tax reform should be to invigorate the price and incentive mechanism which has been substantially distorted by restrictive policies for several decades.

Theoretical issues in tax reform The positive theory of taxation suggests that the particular features of the developing countries require different tools of analysis and structure of the models. A list of the special features of the developing countries for tax analysis includes: * predominant primary sector; * economic and social dualism; * segmentation of labour and capital markets; * high poverty and inequality; * planning and economic regulation; and * corruption and tax evasion. Broadly, there are three approaches for tax reform analysis of the developing countries. First, there are theoretical general equilibrium models with different sectors that analyse the effects of alternative tax reforms in mathematical formulation. Second, there are econometric models based on the above general equilibrium approach.

Third, there is a variety of computable general equilibrium models (CGE) (see Burgess and Stern (1993) survey). The normative tax theory uses a combination of positive theory and value judgements involving balancing of the economic criteria of efficiency, equity, and revenue generation. Direct taxes in India Indian taxation provisions are byzantine and static. The extreme progressivity of income taxes can be seen, for instance, from 1973-74 statutory marginal tax rates of 92 per cent on income in the range of Rs100, 001 to Rs 200, 000, and an incredible 97. 75 per cent on incomes above Rs200, 000, equivalent to US\$6, 450 at the current market exchange rate. Tax rates were high on lower income ranges as well (about 57. 5 per cent on income in the range Rs30, 001 to Rs40, 000 (Gupta, 1982). This tax structure resulted in institutionalized corruption, substantial underground economy, tax evasion, and weak enforcement. Subsequently, the marginal rate of tax on the highest income bracket was reduced to 75 per cent, and then to 60 per cent, and again to 50 per cent. Though the marginal rate currently stands at 40 per cent, it is still high as it starts at income levels just over \$3, 000 (or PPP equivalent of over \$8, 000). Also, there is constant erosion of purchasing power from high inflation and the resulting bracket creep. The corporate rate of taxation is also high at 45 per cent for widely held companies and 50 per cent for closely held companies, and foreign company branches attract a 65 per cent tax rate. There is a 15 per cent surcharge on all the foregoing rates where taxable income exceeds Rs75, 000 (about US\$2, 381), but foreign companies are exempt. There is a concessional rate of 20 per cent for venture capital companies. Withholding tax is payable on gross payments in the following manner: dividends 25 per

cent, interest 25 per cent, technical fees 30 per cent, royalties 30 per cent, and other 65 per cent. Individual income tax rates and the size of individual income tax in the total revenue are given in Table I and Table II respectively. It can be seen that income tax forms about 9 per cent of the total tax revenue (see also Chelliah, 1989). Other direct taxes also form smaller proportions. The reliance of the Indian tax system is primarily on indirect taxes. This led several economists to suggest measures like broadening of the direct tax base, higher penalties, more effective enforcement etc. In this article, we argue that these proposals fail to consider properly the negative effects of direct taxes, lead to continued distortions and reduce the importance of the price mechanism. We examine this issue from several perspectives. Non-compliance and tax evasion The prevalence of extremely high rates of taxes over several years resulted in institutionalized corruption and tax evasion. Cheung calls it the "India syndrome" in which the rights to corrupt are systematized through regulations and licences and different trades are associated with exclusive corruption rights (see Cheung (1992) and comments on Cheung by Becker (1992) and Coase (1992)). It is normal for all businesses to keep two or multiple account books to conceal tax liability. Acharya et al. (1986) reported that in India approximately 50 per cent of legally reportable income is untaxed. A confidential survey by Policy Group (1985) concluded that approximately three-quarters of all Indian tax auditors accept bribes (Besley and McLaren, 1993; Chander and Wilde, 1992; Mohammed and Whalley, 1984; Tanzi, 1993; Wahlund, 1992). The high taxation coupled with double digit inflation resulted in a fall in tax compliance, as illustrated in Figure 1. It can be seen that tax compliance fell

by 20 per cent in the 1970s and a further 12 per cent in the 1980s. The conviction rate also registered substantial reduction[1] (National Institute of Public Finance and Policy, 1992). Sectoral equity issues An important characteristic of developing countries like India is the strong presence of an informal sector. A highly progressive tax structure can extract tax revenue from the organized sector, while the informal sector can resort to widespread tax evasion. This will create inequity in the tax system across the organized and informal sectors (Thomas, 1992). To counter partially this inequity, tax reforms in Sri Lanka, for instance exempted government employees from paying income taxes (Jenkins, 1988). The inequity also extends to the job scene resulting in jobs that yield high rents such as those in the tax department and jobs that do not generate corrupt incomes such as a statistics department. Though the official (and the taxable) incomes are the same, the unaccounted income is substantially high in certain jobs within the government. Another form of inequity comes from the non-taxing of agricultural incomes. Economic well-being issues A fundamental issue in a tax system is the " ability to pay" the tax, though the concept of ability to pay is difficult to apply in practice. The purchasing power of the households in the middle class, including the upper middle class who form the bulk of the direct tax payers in India, is substantially low compared to their counterparts in the OECD countries. The PPPS equivalents in Table I represent the purchasing power of the income, that is, the basket of goods that the level of income can get in comparison with the USA. It is interesting to note that the incomes in higher tax brackets have insufficient purchasing power even for basic necessities. We, for instance, consider expenditure on food

items. An estimate of a low cost " balanced healthy diet" for a family of two adults and two children costs about \$80 per week at 1992 prices (Groom, 1993), thus requiring \$4, 160 per year. If we include other basic needs in terms of other goods including consumer durables, the individual earning income in the top tax bracket will fall below the poverty line by the OECD standards. The saving rate in India to some extent can be explained by " perception" of the adequacy of food consumption as against nutritional norms (see Minhas (1991) for a detailed survey of this issue). Thus the tax brackets are not only arbitrary but also based on relative prosperity in an economy with extremely low wages. The ability to pay as applied in the Indian tax scenario thus fails to take into account the basket of goods the income ought to buy in order to impose the tax. Administrative costs Most tax analysis concentrates on the efficiency issue in terms of " dead weight loss" and distortions. The administrative cost and compliance costs are largely ignored (Gruske, 1989 ; Heady, 1993). These costs are very high in the case of India. Attempts to broaden the tax base in a low wage economy like India will cause additional distortions and will end up raising the " equilibrium level of bribe" (Basu et al. (1992) discuss this issue in a recursive Nash equilibrium framework). Other distortions One fundamental problem faced by many LDCs who are liberalizing and expanding is the infrastructure bottleneck. Irrational and extremely progressive tax structures put a strong constraint on infrastructural improvements as they distort the real estate market drastically. Private parties are unwilling to sell real estate to public institutions for infrastructural development as this results in payment of high taxes (note that in India, capital gains tax was not indexed

to inflation until recently). In several cases, the government acquires private property for infrastructural development through forcible "requisitioning" (in India, placing right to property as a "legal right" and not a "fundamental right" enables the government to take away the property of an individual, paying compensation that is substantially inadequate by market standards and taxable at a high rate as the income cannot be concealed). This process results in bureaucratic red tape and further rent seeking. The federal and state plans that base their analysis and forecasts on official statistics are grossly misleading under extremely progressive tax systems (Thomas, 1992). Furthermore, environment conservation becomes a casualty due to poor infrastructure. Experience from the reforming Latin American countries Finally, we examine the nature and direction of tax reform in Latin American countries and examine the relevance of these tax reforms in the Indian context. In the last decade, there has been a clear tendency towards lower rates of taxation on the individual. Table III shows a sample of 18 Latin American countries for 1979-80 and 1990-91 which have undertaken reforms that resulted in lower marginal tax rates. Some of the reforms may have been inspired by the objective of reducing disincentive effects of the high tax rates and also by more practical considerations of reducing the tax evasion. In 1979 the high-income marginal tax rate was averaging at 48 per cent. By 1991, the rate had reduced to 35 per cent. We can note that the lower tax rate of 25 per cent and high marginal income tax rate of 60 per cent in India are much higher compared to several countries in the sample. Similarly, in 1991 the lower and upper limits are much higher for India compared to other countries in the sample. It may also be noted that all the other countries in

the sample have higher per capita incomes than India, which makes India a low wage and high tax country. Many countries such as Argentina, Brazil, Costa Rica, Ecuador, Mexico, Peru and Venezuela have abandoned complex tax schedules involving a great number of tax rates, in favour of a small number of tax brackets. Bolivia has reformed its personal income tax rate to the most simple scheme: just a flat rate of 10 per cent. Only two countries have marginal tax rates of over 50 per cent for personal income in 1991: the Dominican Republic and Panama. In these two cases, the tax structure remained almost the same as in 1979. All countries that reformed the personal income tax in the past decade scaled downward the overall structure of rates. On average, the high marginal income tax rate of the personal income tax has tended to approach the corporate income tax rate. There is a tendency for the personal exemption level to rise among the Latin American countries. Between 1979 and 1991, the average exemption level rose from less than half of per capita GDP to greater than one-and-a-half times per capita GDP. In the case of corporate income tax, many Latin American countries have reduced the corporate income tax rate. The simple average of tax rates has diminished from about 44 per cent in 1980 to 36 per cent in 1991 (Table IV). Of the 18 countries in the sample, eight countries reduced the corporate tax rate between 1980 and 1991, five countries marginally increased the tax rate, one country replaced the corporate income tax by a net worth tax and the rest maintained the tax rates. In 1980, most sample countries had progressive corporate income tax rates. In the sample, 11 countries had progressive tax rates and seven countries had uniform rates in 1980. This proportion remained essentially the same in 1991.

despite the realization that a uniform rate is easier to control than a progressive rate. However, the number of tax rates seems to have fallen. The treatment of capital gains has also not changed in that 11 countries (though not the same ones) continue to treat capital gains as normal profits within the overall corporate tax structure (Table V). The number of countries that exempt capital gains or tax them at lower rates continues to be similar. However, some changes in particular countries have, of course, taken place. Bolivia and Costa Rica have changed capital gains treatment from normal taxation to exemption. Argentina and Ecuador have switched in the opposite direction: from taxation of capital gains at reduced rates towards taxation as normal profits. Other countries, such as Colombia, calculate this minimum contribution as a percentage of net worth. Bolivia has completely replaced the corporate income tax by a tax on net worth. Ecuador, El Salvador and Uruguay have a tax on net worth or assets but not necessarily as a minimum contribution to the corporate tax. Costa Rica and Paraguay legislate taxes on fixed assets or real estate in addition to normal income taxes (for an analysis of tax reforms in Asian countries, see Ito and Krueger (1992)).

Conclusion
Tax reform should be guided by practical considerations and the important objective of the direct tax reform should be to eliminate distortions and invigorate the market mechanism and the incentive system. Direct taxes do not play an important role in the generation of revenue. Some economists, therefore, erroneously suggest that there is a need to increase the direct tax base and increase the proportion of the direct taxes in total tax revenue. Recent proposals include broadening of the tax base, taxation of agriculture, inclusion of fringe benefits for income tax purposes, higher penalties,

stronger enforcement, etc. These measures are counter-productive in a scenario of institutionalized corruption. It should be noted that the extreme progressivity of direct taxes along with a plethora of policy induced distortions over several decades resulted in a vicious circle of institutionalized corruption, inadequate infrastructure, distorted markets, and environmental degradation. The theoretical and econometric models dealing with tax reform analysis are inadequate to account for these complexities. It was shown that India is a high tax country with low per capita income. The transaction costs of reforming the system are high (Cheung, 1992), and the right sequence of a liberalization process should include elimination of the individual income taxes and the capital gains taxes altogether, and substantial lowering of corporate taxes. A single flat rate at a very high income level for individual and corporate income taxes, and capital gains taxes, may be considered as an alternative for the sake of political feasibility. This will result in a positive investment climate for both domestic and foreign investment, regardless of the speed of liberalization. Reforming direct taxes is a politically viable and important policy measure and should preferably precede other liberalization programmes. As the social costs of the direct tax system in India are high, elimination of these taxes is a highly desirable policy option in the short run. The revenue loss resulting from the elimination of these direct taxes can be easily matched, partly by the attrition of the staff and transfers of the staff and infrastructure to other departments, and more importantly by the buoyancy in the economy due to a better investment climate, infrastructure, and efficient market systems.

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1. Introduction Inflation is, at the same time, one of the most dreaded and one of the most misunderstood of economic phenomena. We know from experience, combined with cogitation, that the prices of commodities will, over time, rise and fall, responding to the pulls and pushes of demand and supply. A failure of a particular crop or a flash fashion for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected glut in the production of onions will cause the price of onions to fall. These price movements are nature's way of signalling to consumers that they should consume less of the commodity facing shortage and more of the good in glut and to producers to produce more of what is in short supply and less of what is available in plenty. To even out these ebbs and flows of prices would be folly, as we know from countless examples of misdirected government interventions. Inflation, on the other hand, has little to do with these changes in relative prices of goods and services. It refers, instead, to a sustained rise in prices across the board, that is, a phenomenon where the average price of all goods is on an increasing trajectory for some stretch of time. Of course, this may be accompanied by changes in relative prices. For the common person, there is something threatening about the phenomenon of inflation,

especially on those occasions when the rise in prices of goods is not matched by an equivalent increase in the price of labour. While it is true that we do not fully understand inflation and, to that extent it remains a threat, what is comforting is that years of data collection and theoretical research have given us deep insights into this troubling phenomenon. And even though we do not fully understand its origins, as in the case of the emperor of maladies, we have developed techniques and policy interventions that can control it. For some of these antidotes, there is good reason to be cautious when using them and in deciding what dose to administer, since each such policy intervention comes with side effects. But it is a testimony to the advance of economics as science that the spiralling hyperinflations that occurred ever so often till even half a century ago, now seem to be a matter of history.

Inflation is an emotive matter and its occurrence gives rise, understandably, to popular resentment. 2. Inflation in India Before getting into the analytics of inflation, it is useful to have the basic facts on the table. India is right now in the midst of an inflationary episode that has gone on for 17 months. It began in December 2009, when the WPI inflation climbed to 7.15%. It continued to rise, peaked in April 2010, at just short of 11%. Thereafter, it has been on a broadly downward trajectory. What has caused some concern once again is that there was a small pick-up in inflation in December 2011 and also because the downward trajectory has been disappointingly slow. Before this 17-month run, we had one year of negligible inflation; but just prior to that there was another rally from March 2008 to December 2008, when WPI inflation hovered in and around 10%. Before these two rallies in quick succession, India had very little inflation for a dozen years. There were

occasional months when inflation would exceed 8% and not a single month when it was in double digits during these twelve years of relative price stability. For reasons of completeness it may be mentioned that independent India's highest inflation occurred in September 1974, when inflation reached 33.3%. Arguably our worst inflationary episode was from November 1973 to December 1974, when inflation never dropped below 20% and was above 30% for four consecutive months starting June 1974. Table 1 gives the full inflation data for WPI and food prices from 1971 to the most recent available. What is good performance and what is bad depends on the yardstick. Even during the dozen years of price stability we had more inflation than in virtually any industrialized country in recent times but, in comparison to most emerging market economies and developing nations in the world, India's performance was creditable. One reason for the concern with the past 17 months inflation-run is the fact that since the mid nineteen nineties and all the way till 2006 we had price stability. This concern has led to the talk of runaway inflation and hyperinflation. It is however important to get the perspective right. We are nowhere near hyperinflation—usually described as inflation over 50% per month (Cagan, 1956). The world's biggest inflations occurred in Europe, once around 1923 and again around 1946. Comparable inflations have occurred in Russia from December 1921 to January 1924, in Greece in 1943, in Zimbabwe in 2008, in Germany in 1923 and in many other instances. The German hyperinflation of 1923 may well be the most analysed and diagnosed inflation. It played havoc with the economy, created political tensions which contributed to the rise of Nazism, and also caused psychological disturbances. Tighter monetary and fiscal measures brought

inflation down in the 1980s and, eventually, restored high growth. This wide range of experience from around the world and prodigious amounts of research have vastly enhanced our understanding of inflation. The relatively good inflation record among all industrialized nations and emerging market economies over the last two decades is testimony to this. However, this experience has also taught us that there is a lot that we do not understand and 11 that the drivers of inflation, like bird flu, can change over time rendering standard antidotes less effective and calling for fresh research and, maybe, new medicines. For years, the US Fed kept a control on prices by buying and selling government bonds which was the other side of, respectively, releasing money into and absorbing money from the economy. However, money is not the only medium of exchange. There are 'near monies' that can do some of the work for money. People can use all kinds of other commodities and papers to trade goods. If, for instance, government bonds were fully acceptable as a medium of exchange, then the central bank selling bonds and collecting money would have very little impact on the economy. It is the appearance of 'near monies' that has compelled the US Fed to change some of its strategies for maintaining stable prices. Since these endogenous features of the economy can vary from one country to another, this calls for independent research in each nation. Over the last few years there is a sense that the inflation faced by emerging economies is changing some of its stripes, thereby demanding not just greater resolve but new ideas in order to have price stability. Rakshit (2011) points to the somewhat unusual divergence between CPI inflation and WPI inflation in recent times, even though it should be pointed out that the two have

converged once again over the last six months. We can also see from Figure 1 that the volatility of inflation also seems to have changed. However, it can be argued that for most purposes and certainly in the context of this paper, it will not matter very much which particular index is used. It is true that there was considerable divergence between the WPI on the one hand and the several consumer price indices (CPIs) that India tracks, during 2010 but this was exceptional; by and large inflation measured by these indices tend to converge over time. Moreover, theoretically, it is not clear that one is better than the other. It is true that the WPI does not track the price of services, which is increasingly the major part of India's value added in GDP. However, since services constitute an important input for manufacturing and agricultural products, it is arguable that the price of services gets indirectly reflected in the WPI. Further, in a nation with as much income and living-condition disparity as in India, it is difficult to think of a representative consumer in a meaningful way. As a nation India tries to get around this problem by computing at least three different kinds of consumer price indices, for three different classes of consumers. This raises the vexing question of which of these to use for crafting national policy. The most popular among the consumer price indices, the CPI for industrial workers or CPI (IW), has another rather interesting problem. For most bureaucrats and government workers, salaries in India are indexed by using the inflation rate as measured by CPI (IW). Since it is government workers and bureaucrats who collect the data for constructing the CPI (IW) index there is a potential conflict of interest, with the possibility of a tendency to record higher numbers wherever the opportunity for this arises. Indeed, a direct study of

the two indices shows that the CPI (IW) index has grown faster consistently since around August 2008. This can of course happen for natural reasons because the two indices after all do not track the same commodities. However, it so happens that they do also track several of the same commodities. So one possibility is to take the commodities common to the two indices, and change the weights in one to match with the weights in the other. This still leaves one problem. The CPI (IW) is computed with 2001 as the base year, whereas the WPI is computed with 2004-05 as base year. But this is very easy to change to get both indices to the same base year. Once we make these changes we can see if there is an upward bias in the CPI (IW). Doing precisely the above exercise and plotting the two indices on the same graph does reveal a small but fairly systematic upward bias in the CPI (IW), as compared to the WPI. In this exercise we made 2006 the base for both indices. So both indices start off at 100 in April 2006. Almost immediately after that the CPI (IW) moves up faster and then on, barring six or seven months, the CPI (IW) outperforms the WPI. This was a quick preliminary exercise and will need more careful study but it does suggest a small upward bias in the consumer price index on which the salary increases of the people engaged in computing the numbers depends. On the other hand, it also turns out that if we compute the inflation between the two indices between April 2006 and January 2011, there is little difference between the two. Hence, for policy and analysis, especially since our instruments for managing inflation are at best blunt, the differences between the wholesale price inflation and consumer price inflation are not sufficient to warrant preferring one over the other. With this digression behind us, let me now return to the main

concerns of this paper. As is evident from Figure 1, while inflation, both for WPI and food, is clearly on the rise since 2000, it seems to be distinctly less volatile than it used to be, for instance, before the mid-1980s. There is also a marked divergence between food and non-food inflation, since October 2008, as is clear from Figure 2. A similar exercise is being done in a paper-in-progress by Anant (2011), which is throwing up some rather interesting implications, including on the use and timing of monetary policy instruments.

14 Figure 1 Before 1982 we had some stretches of very low inflation but also peaks of a kind that, fortunately, we do not see any longer. This is in part a sign of learning on the part of government and the RBI, whereby they can manage price instability better than they did in the past but in could also be an indicator of the changing character of inflation Figure2: Figure 3 reveals another interesting pattern. In this figure we show the comparative price movements of perishable food items and non-perishable food items. Non-perishables can be stored and so, with rational individuals, we would expect people to store in times of plenty and draw on the stored food in times of shortage. This would lead us to expect less volatility and also less inflation, for non-perishables. The figure seems to bear this out, especially over the last decade. This underlines one important point. This makes us realize that hoarding food should not be castigated under all circumstances. It can lead to price stabilization. Also, for many big retail suppliers there is need to store food before 16 they can take them over to the retail outlets. A thoughtless use of the essential commodities act, treating all acts of storing and hoarding as unlawful, can do a lot of damage. The aim of the law should be to stop hoarding that is used by large traders to deliberately manipulate prices.

Reactive hoarding in response to price cycles, on the other hand, has much to commend. Figure 3 Some of the above discussion explains (albeit in a somewhat tautological way) why the difference between CPI inflation and WPI inflation has been more marked in recent times. However, this also points to a new-found resilience of the Indian economy. It is arguable that earlier, our overall inflation was powerfully driven by the agricultural sector. What happened to food prices affected everything else and so the two indices moved more or less in tandem. Over time, the share of agriculture in the total GDP has fallen and the growing strength of the economy means that food prices alone may not be in the driver's seat the way they were for the first several decades after independence. This has an immediate policy implication that is worth noting here. In controlling overall inflation, food prices may not be as important as they were in the past. Of course, controlling food inflation is important in itself, since such a large segment of India continues to be poor and any inflation in food prices hurts them disproportionately. This is discussed at some length in this year's Economic Survey (Government of India, 2011). But in controlling overall inflation, we have to turn our attention much more to macro demand management--fiscal and monetary--though, even here, we will need to look for newer channels of policy action. Before going off the topic of food and commodities management and inflation, it should be put on record that, even apart from the connection of commodities with inflation, this is a topic of considerable importance in itself. A lot of our basic commodities--food grains, kerosene and LPG, for instance--are supported through government subsidies. This is as it should be in a developing economy. The idea is that

the poor need to be specially aided to get access to these critical items. However, most of this debate turns on the fiscal viability of the subsidy. What this misses out on is that how we administer this subsidy has huge implications for efficiency, even when it is fiscally neutral (Basu, 2011).

Consider food grains. Studies show that an astonishingly high fraction of the grain meant to be given to the poor and vulnerable through our Public Distribution System (PDS) get diverted, presumably sold off at illegal high prices or wasted. According to a study by Khera (2010), in 2001-02, 39% of food grain meant to reach the poor through India's PDS was lost to leakage and diversion. A more recent study by her (Khera, 2011; see also Jha and Ramaswamy, 2010) shows that the problem has got worse. In 2007-08, the diversion of food grain was at 43.9%. It had risen to as high as 54% in 2004-05. This disappointing story is mirrored in the fact that only a fraction of the poor get their food from PDS stores. In 2004-05 only 17% of the poorest quintile households received food from PDS stores. And for some poor states, such as Bihar and UP this figure is as low as 2% and 6% respectively (Parikh, 2011). Clearly, this is unacceptable, since it tends to bloat fiscal expenditure, causing inflation across the board. We have to think of a major overhaul of our public distribution system and give subsidies, as far as possible, by making direct transfers to the poor, who should then be allowed to buy their food from any store, private and public. Fortunately, the government has taken steps to move towards a major overhaul, with the announcement in the last Union Budget, presented in February 2011, that we will move over to direct transfers to a targeted population, in lieu of the earlier system of trying to deliver subsidized for kerosene, LPG and fertilizers to all. There has

also been some discussion in government arguing that improving supply chain management through modern retailing can help cut down the gap between farm gate price and retail price but there are also some voices of dissent on this (see, for instance, Singh, 2011) A related but distinct problem occurs in the case of diesel and petrol. If we try to help consumers by holding the price of petrol low and constant, our consumers will not economize on petrol and switch to substitutes when petrol supply runs short and global price rises. By holding prices constant a major signal for altering behaviour to suit changing supply conditions gets switched off. This is a much more important consideration than the impact on the fiscal deficit. Since till recently we have, by and large, held the price of petrol and diesel constant, we have contributed to these inefficiencies. People in India ply large luxury cars liberally, unmindful of when the global price of fuel is high and when low. It should be pointed out that even the government indulges in a fair amount of this waste and this is harder to control through price changes. Since many users of fuel do not have to pay for it out of their own pockets, they tend to use this resource without being adequately sensitive to the level of its price. This is an embarrassing topic and, maybe for that reason, is seldom talked about. But it is important to face up to these inconvenient questions so that we can devise new mechanisms to increase overall efficiency. A lot of our problems are rooted in these micro inefficiencies and we need to work to improve them. However, I shall now turn to the subject of macroeconomic policies for combating inflation.

3. Predicting Inflation and Controlling It:

There are agencies, in every nation, that are entrusted with the task of both forecasting inflation and trying to adopt policies that keep

inflation under control. A nation's central bank tries to do this as does the treasury or ministry of finance. But this twin tasking gives rise to an intriguing conundrum, which is specific to the social and economic sciences and has few parallels in engineering and the natural sciences, even though Heisenberg's famous uncertainty principle could be thought of as a counterpart to this from the natural sciences. It is widely believed and is arguably true that when a well-informed responsible government or quasi-government agency makes inflation forecast that, in itself, can cause the course of inflation in the future to change. This is because, at least in the short run, the actual inflation rate depends, in part, on what people expect the inflation rate to be. Inflation can get worsened by the very fact of higher inflationary expectations and likewise prices can be stabilized, to a certain extent by virtue of leading people to expect that prices will be stable. Thus, we often hear about how a policymaker stoked inflation by saying in public that inflation will go up. Usually, behind such an observation is the critique that no one should be as irresponsible as to fuel inflation by making such statements. But this immediately places the Central Bank and the Treasury in a dilemma that Ahamed (2009) alludes to and may be logically impossible to resolve. The above phenomenon is explained in following figure: 4.

Benefits for the Poor and Inflation Inflation management and control based on a particular argument which was being used in India in the context of the last seventeen months of inflation, which began with a sharp upward rally of food prices. Food price inflation peaked in the early months of 2010, when it exceeded 20%. Non-food inflation would pick up a little later. It has often been argued that the sharp rise in food prices in 2009 and the early months

of 2010 were likely caused by the drought of 2009 which led to a decline in food grains production but also by the fact that government had considerably expanded income support to the poor, for instance, through the NREGS and loan waivers to poor farmers. This explanation has run into controversy.. The Deputy Chairman of the Planning Commission, Montek Singh Ahluwalia, has argued, as have several others (see, for instance, Government of India, 2011), that the greater benefits given to the poor may have caused some of the initial food price inflation in 2009 and early 2010. Let me refer to this as the " benefits-based inflation hypothesis. " This hypothesis has often given rise to a raucous debate with some misparaphrasing this into: " The poor are to be blamed for the inflation. " As far as I know no one has made that claim, so that can be safely put aside. A more serious criticism of this claim that has been made may be summed up as follows: If it were indeed true that it is the greater demand for food on the part of the poor that caused the inflation, then we would expect to see the poor consuming more. But (so goes this argument) there is no evidence for this. Hence, the benefits-based inflation hypothesis is invalid. Let D_0 , in Figure 5, be the aggregate demand curve for food of the poor people. Now suppose that the poor get an income supplement which raises their demand for food. Then the new demand curve will be like D_1 . This however does not in itself mean that the poor will actually consume more. If the supply of food that is available to the poor is unchanged or, in other words, the supply curve of food is completely inelastic, then the increased demand will not translate into greater consumption of food but it nevertheless is the cause of food price rising. This is shown in Figure 5 5. Interest Rates and Liquidity Inflation is one of those

peculiar phenomena which, even without our understanding its causes and triggers anywhere near fully, we have learned several techniques for controlling. The controls are often imperfect and, further, each one comes with side effects, which calls for some judgment regarding how strongly we can administer these medicines, but what is comforting is that, thanks to sustained research, we at least have several known antidotes. It is worth clarifying that by inflation I am here referring to an overall increase in prices and not the relative price increases of some goods. When the price of some goods increases, we can respond by trying to supply more of those goods (by diverting effort from the production and supply of other goods). But if the prices of all or virtually all goods increase, there is little we can do in terms of supply, because there is no known way of suddenly providing more of all goods. If there was a way to do so, we should have done so already and made everybody better off. This is the reason why, when there is overall higher inflation, we have no choice but to turn to some form of demand management, even while working on easing specific supply bottlenecks that may exist. The case for easing supply bottlenecks and enhancing productivity is there at all times, with or without inflation, since that increases welfare. Inflation, on the other hand, is a mismatch between overall supply and overall demand and certainly demand appropriate policy action. Overall demand in the economy comes from many sources--corporates, farmers, labourers, housewives and government. So what any single agent can do is limited. Also, actions by other agents can undo what one agent does. This is what contributes to making inflation one of the hardest problems to manage--the emperor of economic maladies. While we think of promises mostly in

bilateral terms, the most important 'economic' promise, one that has made modern civilization possible, is the mysterious promise represented by money—the note in your wallet or the bank balance in your account, which in itself is of no value but is a record of work you did for which you are yet to redeem goods and services. Money is nothing but a generic promise from society—government being the most important representative of that—that you will be able to change these useless bits of paper for actual goods and services in the future. It is this which enables the worker who toils all day to not insist that his employer hand over to her food, clothing, and shelter material in the evening in exchange for the hard work. Instead, she accepts money. Money is a kind of pledge to her by society at large. She can redeem that pledge at leisure and in small measures--buying food, shelter, education, as and when she needs these. Inevitably the central bank and the nation's treasury became the managers of a nation's liquidity and, through that, the value of money and the level of prices. In India, the major instruments for managing liquidity are the repo, reverse repo. It has been argued elsewhere (see Government of India, 2011, Chapter 2) that this principle of one-economy one-central bank has got weakened in recent times. With globalization the world economy is increasingly beginning to look like a single economy, but, to the extent that the world has many central banks with the right to create money, we are tending to get back to the kind of world we worked hard to get out of. This is one phenomenon (multiple money-creating authorities in an increasingly unique global economy) that is dramatically altering the nature of inflation in recent times. As Reddy (2011, Chapter 4) warned in 2009, the injection of liquidity around the world to

jumpstart various economies caught in recession created the risk of inflation.

6. A Digression on Capital Controls The above analysis draws our attention to the importance of detail in designing economic policy. Minor flaws can have large unintended consequences. This is a nice occasion to illustrate a similar point about policies to restrict capital flows. There are contexts where it is reasonable for a nation to place restrictions on capital flows. Even the IMF has recently endorsed the need for such restrictions in certain situations. Suppose for some form of credit, the Indian demand and the international supply are as illustrated in Figure 8. This could be the case of ECBs. For simplicity let me go along with a simple neo-classical analysis. Left to itself, the amount of borrowing that would occur in this market is shown by L^* . Let us now suppose that government decides that so much of foreign borrowing is undesirable and we should restrict the total borrowing to L instead, as shown in Figure 7. Hence, government decides to place a restriction on debt inflows into India to ensure that the total flow remains within L . I am not here questioning the merit of this decision, but simply taking it as given. The aim is to illustrate how different microeconomic ways of achieving this macroeconomic target can have very different implications for the economy. Suppose that government decides to implement this limit by restricting the supply of credit that comes into the nation. This will leave the demand curve, DD' , unchanged but the supply curve will be now given by SBM . By locating the point of intersection between the new supply curve and the demand curve, it is easy to see that the total credit will be L . An alternative intervention is to leave the supply unchanged but place restrictions on the aggregate demand for credit by suitably rationing the amount that Indian

firms can borrow. In this case the supply curve remains SS' , whereas the demand curve becomes DAL . Once again the total credit coming into India will be L . Both interventions achieve the objective of limiting credit flows into India, but there is one big difference. In the former intervention, the interest rate will be r_L , whereas in the latter intervention, the interest will be r_H . Thus, in one case Indian borrowers get to have credit at a much lower interest rate than in the other case, with large implications for efficiency, corporate profitability and growth. Evidently, a policy intervention without careful attention to detail can easily have us make a mistake on this. The Government of India has worked out a wide range of measures to control inflation and to ensure stable conditions as well as to prevent speculators from taking an undue advantage of the conditions of scarcity.

1) Demand management: The government targets the demand side of inflation mainly controlling the money supply in the country. The price policy of the government has changed overtime . The policy has relied on fiscal and monetary measures with a view to check the demand of the general public for goods and the services (by decreasing the money with them).

a)Fiscal measures The Indian government has always tried to control its own expenditure and keeping the revenue and fiscal deficit minimum. In 1984, the Government of India announced a package of programmes to curtail public expenditures, to postpone recruitment to government jobs etc. But the measures were not effective. Instead the governments (both central and state) have always adopted a policy of deficit budgeting, revenue deficit and fiscal deficit. Thus instead of checking prices, government policy has actually pushed up prices. But since 1990-910 the need to reduce fiscal deficit has

gained importance. The budget of July 1991-92 took the first decisive action to limit the fiscal deficit from 8.4% in 1990-91 to 6.2% in 1991-92 and to further 3.1% in 2007-08. (This was in compliance with the conditions imposed by IMF). The Fiscal policy for 2010-11 is being guided by the principles of gradual adjustment from the fiscal expansion of 2008-06 and 2009-10 (Because of global financial crisis). The adjustment path is being so calibrated that it would not affect the revival process and at the same time stabilize the debt to GDP ratio of the Government in the medium term. In the Medium Term Fiscal Policy Statement of 2009-10, the Government had enumerated the roadmap for fiscal consolidation during 2010-11 and 2011-12. The Government is adhering to these commitments made in July 2009 and has also benefitted from the recommendations of the 13th Finance Commission on fiscal consolidation. Accordingly fiscal deficit in BE 2010-11 has been reduced to 5.5 per cent of GDP. This correction of fiscal deficit is attributed to reduction in total expenditure by 0.6 per cent of GDP (from 16.6 per cent in BE 2009-10 to 16.0 per cent in BE 2010-11), increase in gross tax revenue by 0.4 per cent of GDP (from 10.4 per cent in BE 2009-10 to 10.8 per cent in BE 2010-11) and increase in non-debt capital receipt by 0.6 per cent of GDP (from 0.1 per cent in BE 2009-10 to 0.7 per cent in BE 2010-11). All the above numbers are with reference to the revised GDP numbers.

b) Monetary measures: This is done by RBI; it involves extensive use of general and selective credit control measures. In general, RBI uses its monetary policy to achieve a judicious balance between the growth of production and control of the general price level. RBI uses Bank rate, CRR, SLR and open market operations to increase bank credit and expansion of

business activity (during recession) or to contract bank credit and check business and speculative activity (during inflation). Any increase in CRR, Bank Rate, SLR, reverse repo, repo rate results in decreased money with Commercial banks thus money supply in the country decreases and vice versa. Decreased money leads to decreased demand and thus eases the rising prices. [To understand this better read my post on " Important rates of money market", I have dealt with the basics of these rates in that post]. In July 2010 RBI announced that it would update the monetary policy about 45 days after the quarterly review to respond faster to changing domestic and international economic scenarios. The RBI said that such formal mid-cycle announcements would take out the surprise element arising from an off-cycle rate decision as was the case earlier (Although scheduled policy announcements were made once in a quarter, the RBI had intervened at times when situations demanded a policy change). The present RBI governor, D V Subbarao had said that mid-quarter reviews are intended to communicate our assessment of economic conditions more quarterly. The former governor of RBI has supported the RBI's decision of increasing the various interest rates. He said that it is a long term measure to contain inflation and promote healthy growth of the economy. References: 1. <http://www.tradingeconomics.com> 2. <http://www.economywatch.com> 3. <http://www.tradechakra.com> 4. <http://articles.economicstimes.indiatimes.com> 5. <http://indianec.files.wordpress.com> MEARS ASSIGNMENT By Prof. S. P. Das Assignment On Comparative Analysis of Contribution of different sectors to Indian Economy Submitted By: Manolk Manohar Mungale U311023 Comparative Analysis of Contribution of different sectors to Indian Economy

The Economy of India is the ninth largest in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). India has a per capita GDP (PPP) of \$3, 586 (IMF, 129th) as per 2010 figures, making it a low-middle income country. The independence-era Indian economy was inspired by the economy of the Soviet Union with socialist practices, large public sectors, high import duties and lesser private participation characterizing it, leading to massive inefficiencies and widespread corruption. However, in 1991, India adopted free market principles and liberalized its economy to international trade under the guidance of current Prime Minister Manmohan Singh, who then was the Finance Minister of India under the leadership of P. V. Narasimha Rao the then Prime Minister. Following these strong economic reforms, the country's economic growth progressed at a rapid pace with very high rates of growth and large increases in the incomes of people. India recorded the highest growth rates in the mid-2000s, and is one of the fastest-growing economies in the world. The growth was led primarily due to a huge increase in the size of the middle class consumer population, a large workforce comprising skilled and non-skilled workers, improvement in education standards and considerable foreign investments. India is the seventeenth largest exporter and el