Role of government and state financial institutions in indian economy

ASSIGN BUSTER

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Introduction * The Economy of India is the ninth largest in the world by nominal GDP and the fourth largest by purchasing power parity(PPP). The country is one of the G-20 major economies and a member of BRICS. The country's per capita GDP (PPP) was $3, 408 (IMF, 129th in the world) in 2010, making it a lower-middle income economy. The independence-era Indian economy (before and a little after 1947) 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, later on India adopted free market principles and liberalized its economy to international trade under the guidance of Manmohan Singh, who then was the Finance Minister of India under the leadership of P. V. Narasimha Rao the then Prime Minister. Communist policies governed India for sometime after India's Independence from the British. The economy was then characterised by extensive regulation, protectionism, public ownership, pervasive corruption and slow growth. Since 1991, continuing economic liberalisation has moved the country towards a market-based economy. Early Policy Developments * Many early post independence leaders, such as Nehru, were influenced by socialist ideas and advocated government intervention to guide the economy, including state ownership of key industries. The objective was to achieve high and balanced economic development in the general interest while particular programs and measures helped the poor. * India's leaders also believed that industrialization was the key to economic development. This belief was all the more convincing in India because of the country's large size, substantial natural resources, and desire to develop its own

defence industries. * The Industrial Policy Resolution of 1956 greatly extended the preserve of government. There were seventeen industries exclusively in the public sector. The government took the lead in another twelve industries, but private companies could also engage in production. * This resolution covered industries producing capital and intermediate goods. As a result, the private sector was relegated primarily to production of consumer goods. The drawbacks it had… * The government's extensive controls and pervasive licensing requirements created imbalances and structural problems in many parts of the economy. Controls were usually imposed to correct specific problems but often without adequate consideration of their effect on other parts of the economy. For example, the government set low prices for basic foods, transportation, and other commodities and services, a policy designed to protect the living standards of the poor. * However, the policy proved counterproductive when the government also limited the output of needed goods and services. * Price ceilings were implemented during shortages, but the ceiling frequently contributed to black markets in those commodities and to tax evasion by black-market participants. The extensive controls, the large public sector, and the many government programs contributed to a substantial growth in the administrative structure of government. * The government also sought to take on many of the unemployed. The result was a swollen, inefficient bureaucracy that took inordinate amounts of time to process applications and forms. * Business leaders complained that they spent more time getting government approval than running their companies. Current Reforms India's current economic reforms began in 1985 when the government abolished some of its licensing regulations and other competition-inhibiting controls. *

Since 1991 more “ new economic policies” or reforms have been introduced. Reforms include currency devaluations and making currency partially convertible, reduced quantitative restrictions on imports, reduced import duties on capital goods, decreases in subsidies, liberalized interest rates, abolition of licenses for most industries, the sale of shares in selected public enterprises, and tax reforms.

Some more points on the change * The pace of liberalization increased after 1991. * By the mid-1990s, the number of sectors reserved for public ownership was slashed, and private-sector investment was encouraged in areas such as energy, steel, oil refining and exploration, road building, air transportation, and telecommunications. * An area still closed to the private sector in the mid-1990s was defense industry. * Foreign-exchange regulations were liberalized, foreign investment was encouraged, and import regulations were simplified.

The average import-weighted tariff was reduced from 87 percent in FY 1991 to 33 percent in FY 1994. Economic Development Planning * Planning in India dates back to the 1930s. Even before independence, the colonial government had established a planning board that lasted from 1944 to 1946. * Private industrialists and economists published three development plans in 1944. India’s leaders adopted the principle of formal economic planning soon after independence as an effective way to intervene in the economy to foster growth and social justice. * The Planning Commission was established in 1950.

Responsible only to the prime minister, the commission is independent of the cabinet. The efforts of the Govt through the Five Year plans * The First Five-Year Plan (FY 1951-55) attempted to stimulate balanced economic development while correcting imbalances caused by World War II and partition. Agriculture, including projects that combined irrigation and power generation, received priority. * By contrast, the Second Five-Year Plan (FY 1956-60) emphasized industrialization, particularly basic, heavy industries in the public sector, and improvement of the economic infrastructure.

The plan also stressed social goals, such as more equal distribution of income and extension of the benefits of economic development to the large number of disadvantaged people. * The Third Five-Year Plan (FY 1961-65) aimed at a substantial rise in national and per capita income while expanding the industrial base and rectifying the neglect of agriculture in the previous plan. The third plan called for national income to grow at a rate of more than 5 percent a year; self-sufficiency in food grains was anticipated in the mid-1960s. The Fourth Five-Year Plan (FY 1969-73) called for a 24 percent increase over the third plan in real terms of public development expenditures. * The Fifth Five-Year Plan (FY 1974-78) was drafted in late 1973 when crude oil prices were rising rapidly; the rising prices quickly forced a series of revisions. * The Seventh Five-Year Plan (FY 1985-89) envisioned a greater emphasis on the allocation of resources to energy and social spending at the expense of industry and agriculture.

In practice, the main increase was in transportation and communications, which took up 17 percent of public-sector expenditure during this period. The turning points in Plans * The schedule for the Eighth Five-Year Plan (FY 1992-

96) was affected by changes of government and by growing uncertainty over what role planning could usefully perform in a more liberal economy. Two annual plans were in effect in FY 1990 and FY 1991. The eighth plan was finally launched in April 1992 and emphasized market-based policy reform rather than quantitative targets. * The eighth plan included three general goals. First, it sought to cut back the public sector by selling off failing and inessential industries while encouraging private investment in such sectors as power, steel, and transport. * Second, it proposed that agriculture and rural development have priority. * Third, it sought to renew the assault on illiteracy and improve other aspects of social infrastructure, such as the provision of fresh drinking water. Planning and Economy: Conclusion * Four decades of planning show that India's economy, a mix of public and private enterprise, is too large and diverse to be wholly predictable or responsive to directions of the planning authorities. Major shortcomings include insufficient improvement in income distribution and alleviation of poverty, delayed completions and cost overruns on many public-sector projects, and far too small a return on many public-sector investments. * Even though the plans have turned out to be less effective than expected, they help guide investment priorities, policy recommendations, and financial mobilization. Government's Mechanism for Economic development * The main part from the Government in maintaining the economy in a very effective way so as really mean the system, already established is the Reserve Bank of India. RBI plays very important role in indian economy, be it regulating the value of indian rupee or regulating or deregulating the inflation. the flow of money is done via the RBI which keeps the track of transactions as well. * Reserve Bank of India or RBI happens to be the central banking authority of the

country and remains in charge of controlling the monetary policy of thaae rupee in addition to currency reserves. Reserve Bank of India had its inception in 1935 during the heyday of British Empire and was established according to the provisions of the Reserve Bank of India Act, 1934. t is to be noted that RBI, apart from being a leading member of Asian Clearing Union, plays an imperative role in the strategies of development of the Indian government. * Reserve Bank of India or RBI happens to be the first and foremost monetary authority in the dominion of India and with the exception of this attribute, it does act in the role of bank of the national and state governments. * RBI is known to formulate, implement and keep tabs on the monetary policy and it also has to make certain the sufficient flow of credit to productive sectors.

Need of establishment * The Bank was constituted for the need of following: * To regulate the issue of banknotes * To maintain reserves with a view to securing monetary stability and * To operate the credit and currency system of the country to its advantage. Monetary Policy and Fiscal Policy TOOLS OF MONETARY POLICY There are two kinds of tools: Quantitative tools –control the volume of credit and inflation, indirectly. Qualitative tools –they control the supply of money in selective sectors of the economy. Quantitative Tools * Bank Rate

Bank Rate is the rate at which RBI allows finance to commercial banks. Bank Rate is a tool, which RBI uses for short-term purposes. Any revision in Bank Rate by RBI is a signal to banks to revise deposit rates as well as Prime Lending Rate. Role of bank rate is limited in India because The structure of interest rates is administered by RBI Commercial banks enjoy specific

refinance facilities. * CRR All scheduled commercial banks are required to maintain a fortnightly minimum average daily cash reserve equivalent with RBI . The apex bank is empowered to vary this ratio between 3 and 15 per cent.

RBI uses CRR either to impound the excess liquidity or to release funds needed for the economy from time to time. * SLR Every bank is required to maintain at the close of business every day, a minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold etc, in addition to cash reserve requirements. The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR). * Repos and Reverse Repo RBI is empowered to enter a transaction in which two parties agree to sell and repurchase the same security.

Under such an agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and a price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date in future at a predetermined price. Such a transaction is called a Repo when viewed from the prospective of the seller of securities (the party acquiring fund) and Reverse Repo when described from the point of view of the supplier of funds. Thus, whether a given agreement is termed as Repo or a Reverse Repo depends on which party initiated the transaction.

Current Monetary Policy rates * Bank rate-6% * Repo Rate-7. 25% * Reverse Repo rate-6. 25% * SLR-8. 6% * CRR-6% Fiscal Policy * The fiscal policy is concerned with the raising of government revenue and incurring of

government expenditure. To generate revenue and to incur expenditure, the government frames a policy called budgetary policy or fiscal policy. So, the fiscal policy is concerned with government expenditure and government revenue. * Fiscal policy has to decide on the size and pattern of flow of expenditure from the government to the economy and from the economy back to the government. So, in broad term fiscal policy refers to “ that segment of national economic policy which is primarily concerned with the receipts and expenditure of central government. ” * In other words, fiscal policy refers to the policy of the government with regard to taxation, public expenditure and public borrowings. Main Objectives of Fiscal Policy In India 1. Development by effective Mobilisation of Resources The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources. The central and the state governments in India have used fiscal policy to mobilise resources. * The financial resources can be mobilised by :- * Taxation * Public Savings * Private Savings 2. Efficient allocation of Financial Resources * The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc. While Non-development Activities includes expenditure on defence, interest payments, subsidies, etc. But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India’s fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable. 3. Reduction in inequalities of Income and Wealth * Fiscal policy

aims at achieving equity or social justice by reducing income inequalities among different sections of the society. * The direct taxes such as income tax are charged more on the rich people as compared to lower income groups.

Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. * The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society. 4. Price Stability and Control of Inflation * One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by Reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc. . Employment Generation * The government is making every possible effort to increase employment in the country through effective fiscal measure. * Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment. * Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas. 6.

Balanced Regional Development * Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax

holidays, Finance at concessional interest rates, etc. 7. Reducing the Deficit in the Balance of Payment * Fiscal policy attempts to encourage more exports by way of fiscal measures like Exemption of income tax on export earnings, Exemption of central excise duties and customs, Exemption of sales tax and octroi, etc. The foreign exchange is also conserved by Providing fiscal benefits to import substitute industries, Imposing customs duties on imports, etc. * The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export. 8. Capital Formation * The objective of fiscal policy in India is also to increase the rate of capital formation so as to accelerate the rate of economic growth.

An underdeveloped country is trapped in vicious (danger) circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending. 9. Increasing National Income * The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country. 0. Development of Infrastructure * Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measure such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost. 11. Foreign Exchange Earnings * Fiscal policy

attempts to encourage more exports by way of Fiscal Measures like, exemption of income tax on export earnings, exemption of sales tax and octroi, etc.

Foreign exchange provides fiscal benefits to import substitute industries. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. Conclusion * Presently, the economy of India is one of largest economies in the world and will be ranked first by 2050 on global front. Following strong economic reforms from the socialist inspired economy of a post-independence Indian nation, the country began to develop a fast-paced economic growth, as free market principles were initiated in 1990 for international competition and foreign investment. As the free market principles were accepted role of government in Indian economy changed from being a controller to regulator. But still the role of government is relevant as government is the one which decides about the various factors controlling our economy and decides the rules and regulations keeping in mind the welfare of the public. * Therefore government after opening up of economy did not open the sectors which are still in nascent stages and needs some time to become competitive to the foreign players. Apart from this government brings new schemes to help person in personal and professional avenues.