

COMPREHENSIVE STUDY IN INDIAN ECONOMY

UNIT I

Subject matter of economics – basic problems in economics – distinction between micro and macro economics – utility of the study of economics – law of demand and supply – equilibrium – factors determining – elasticity (concept only) – law of valuable returns and returns to scale – (Statement and equilibrium only)

Subject Matter of Economics

Various economists have different views about the subject matter of economics. Adam Smith, in his book “An Inquiry into the nature and causes of Wealth of Nations which was published in 1776 defined economics as an enquiry into the nature and causes of wealth of Nations in other words it lays importance on wealth rather than welfare of human beings. It shows to a man uses wealth produces wealth and how wealth is exchanged and distributed in the economy.

According to the 19th century economists Alfred Marshall,

“Economics is the study of mankind in the ordinary business of life. It enquires how he gets his income and how he uses it. It examines that part of individual and social action, which is most closely connected with the attainment and with the use of material requisites of well-being.

It is on the one side a study of wealth and on the other and more important side is a part of the study of man”. Professor Marshall has shifted the emphasis from wealth to man. Alfred Marshall gives priority to human beings and placed wealth at secondary level.

Basic Problems Of An Economy

If there is a central economic problem that is present across all countries, without any exception, then it is the problem of scarcity. This problem arises because the resources of all types are limited and have alternative uses. If the resources were unlimited or if a resource only had one single use, then the economic problem would probably not arise. However, be it natural productive resources or man-made capital/consumer goods or money or time, scarcity of resources is the central problem. This central problem gives rise to four basic problems of an economy. In this article, we will look at these basic problems in detail.

The Four Basic Problems of an Economy

As discussed in the paragraph above, the central economic problem of scarcity of resources is broken down into four basic problems of an economy. Let’s look at each of them separately.

Basic Problems of an Economy – #1 – What to Produce?

What does a society do when the resources are limited? It decides which goods/service it wants to produce. Further, it also determines the quantity required. For example, should we produce more guns or more butter? Do we opt for capital goods like machines, equipment, etc. or consumer goods like cell phones, etc.? While it sounds elementary, society must decide the type and quantity of every single good/service to be produced.

Basic Problems of an Economy – #2 – How to Produce?

The production of a good is possible by various methods. For example, you can produce cotton cloth using handlooms, power looms or automatic looms. While handlooms require more labour, automatic looms need higher power and capital investment.

Hence, society must choose between the techniques to produce the commodity. Similarly, for all goods and/or services, similar decisions are necessary. Further, the choice depends on the

availability of different factors of production and their prices. Usually, a society opts for a technique that optimally utilizes its available resources.

Basic Problems of an Economy – #3 – For whom to Produce?

Think about it – can a society satisfy each and every human wants? Certainly not. Therefore, it has to decide on who gets what share of the total output of goods and services produced. In other words, society decides on the distribution of the goods and services among the members of society.

Basic Problems of an Economy – #4 – What provision should be made for economic growth?

Can a society use all its resources for current consumption? Yes, it can. However, it is not likely to do so. The reason is simple. If a society uses all its resources for current consumption, then its production capacity would never increase.

Therefore, the standard of living and the income of a member of the society will remain constant. Subsequently, in the future, the standard of living will decline. Hence, society must decide on the part of the resources that it wants to save for future progress.

Distinction between micro and macro economics

| BASIS FOR COMPARISON | MICROECONOMICS | MACROECONOMICS |
|-----------------------------|---|---|
| Meaning | The branch of economics that studies the behavior of an individual consumer, firm, family is known as Microeconomics. | The branch of economics that studies the behavior of the whole economy, (both national and international) is known as Macroeconomics. |
| Deals with | Individual economic variables | Aggregate economic variables |
| Business Application | Applied to operational or internal issues | Environment and external issues |
| Tools | Demand and Supply | Aggregate Demand and Aggregate Supply |
| Assumption | It assumes that all macro-economic variables are constant. | It assumes that all micro-economic variables are constant. |
| Concerned with | Theory of Product Pricing, Theory of Factor Pricing, Theory of Economic Welfare. | Theory of National Income, Aggregate Consumption, Theory of General Price Level, Economic Growth. |
| Scope | Covers various issues like demand, supply, product pricing, factor pricing, production, consumption, economic welfare, etc. | Covers various issues like, national income, general price level, distribution, employment, money etc. |

| BASIS FOR COMPARISON | MICROECONOMICS | MACROECONOMICS |
|----------------------|---|---|
| Importance | Helpful in determining the prices of a product along with the prices of factors of production (land, labor, capital, entrepreneur etc.) within the economy. | Maintains stability in the general price level and resolves the major problems of the economy like inflation, deflation, reflation, unemployment and poverty as a whole. |
| Limitations | It is based on unrealistic assumptions, i.e. In microeconomics it is assumed that there is a full employment in the society which is not at all possible. | It has been analyzed that 'Fallacy of Composition' involves, which sometimes doesn't prove true because it is possible that what is true for aggregate may not be true for individuals too. |

Importance of the Study of Economics:

The importance and utility of the subject of Economics can be judged from this fact that it is now considered to be one of the most important and useful subject as compared to any other branch of knowledge. The reasons for gaining its importance are that it makes human welfare its direct and primary concern.

It helps in raising the quality of economic life. As it greatly helps in the solution of economic and social problems so it exercises an over-whelming influence on the minds of the people. In the words of Durbin:

“Economics is the intellectual religion of the day”.

About the importance of Economics Malthus remarks:

“Political economy is perhaps the only science of which it may be said that the ignorance of it is not merely a deviation of good but produces great positive evil”.

Edmund Burks is not wrong in saying that:

“The age of chivalry has gone, that of sophistry, economists, and calculators has succeeded”.

The Law of Supply and Demand

The law of supply and demand is a theory that explains the interaction between the sellers of a resource and the buyers for that resource. The theory defines how the relationship between the availability of a particular product and the desire (or demand) for that product has on its price. Generally, low supply and high demand increase price and vice versa.

Understanding the Law of Supply and Demand

The law of supply and demand, one of the most basic economic laws, ties into almost all economic principles in some way. In practice, supply and demand pull against each other until the market finds an equilibrium price. However, multiple factors can affect both supply and demand, causing them to increase or decrease in various ways.

Law of Demand vs. Law of Supply

The law of demand states that, if all other factors remain equal, the higher the price of a good, the less people will demand that good. In other words, the higher the price, the lower the quantity demanded. The amount of a good that buyers purchase at a higher price is less because as the price of a good goes up, so does the opportunity cost of buying that good. As a result, people will naturally avoid buying a product that will force them to forgo the consumption of something else they value more. The chart below shows that the curve is a downward slope.

Like the law of demand, the law of supply demonstrates the quantities that will be sold at a certain price. But unlike the law of demand, the supply relationship shows an upward slope. This means that the higher the price, the higher the quantity supplied. Producers supply more at a higher price because selling a higher quantity at a higher price increases revenue.

Unlike the demand relationship, however, the supply relationship is a factor of time. Time is important to supply because suppliers must, but cannot always, react quickly to a change in demand or price. So it is important to try and determine whether a price change that is caused by demand will be temporary or permanent.

Economic equilibrium is a condition or state in which economic forces are balanced. In effect, economic variables remain unchanged from their equilibrium values in the absence of external influences. Economic equilibrium is also referred to as market equilibrium.

Economic equilibrium is the combination of economic variables (usually price and quantity) toward which normal economic processes, such as supply and demand, drive the economy. The term economic equilibrium can also be applied to any number of variables such as interest rates or aggregate consumption spending. The point of equilibrium represents a theoretical state of rest where all economic transactions that “should” occur, given the initial state of all relevant economic variables, have taken place.

Types of Economic Equilibrium

In microeconomics, economic equilibrium may also be defined as the price at which supply equals demand for a product, in other words where the hypothetical supply and demand curves intersect. If this refers to a market for a single good, service, or factor of production it can also be referred to as partial equilibrium, as opposed to general equilibrium, which refers to a state where all final good, service, and factor markets are in equilibrium themselves and with each other simultaneously. Equilibrium can also refer to a similar state in macroeconomics, where aggregate supply and aggregate demand are in balance.

Factors which Determine the Demand for Goods

1. Tastes and Preferences of the Consumers:

An important factor which determines demand for a good is the tastes and preferences of the consumers for it. A good for which consumers’ tastes and preferences are greater, its demand would be large and its demand curve will lie at a higher level.

People's tastes and preferences for various goods often change and as a result there is change in demand for them. The changes in demand for various goods occur due to the changes in fashion and also due to the pressure of advertisements by the manufacturers and sellers of different products.

2. Incomes of the People:

The demand for goods also depends upon incomes of the people. The greater the incomes of the people the greater will be their demand for goods. In drawing a demand schedule or a demand curve for a good we take incomes of the people as given and constant. When as a result of the rise in incomes of the people, the demand increases, the whole of the demand curve shifts upward and vice versa.

3. Changes in the Prices of the Related Goods:

The demand for a good is also affected by the prices of other goods, especially those which are related to it as substitutes or complements. When we draw a demand schedule or a demand curve for a good we take the prices of the related goods as remaining constant.

4. The Number of Consumers in the Market:

We have already explained that the market demand for a good is obtained by adding up the individual demands of the present as well as prospective consumers or buyers of a good at various possible prices. The greater the number of consumers of a good, the greater the market demand for it.

5. Changes in Propensity to Consume:

People's propensity to consume also affects the demand for them. The income of the people remaining constant, if their propensity to consume rises, then out of the given income they would spend a greater part of it with the result that the demand for goods will increase.

6. Consumers' Expectations with regard to Future Prices:

Another factor which influences the demand for goods is consumers' expectations with regard to future prices of the goods. If due to some reason, consumers expect that in the near future prices of the goods would rise, then in the present they would demand greater quantities of the goods so that in the future they should not have to pay higher prices.

7. Income Distribution:

Distribution of income in a society also affects the demand for goods. If distribution of income is more equal, then the propensity to consume of the society as a whole will be relatively high which means greater demand for goods. On the other hand, if distribution of income is more unequal, then propensity to consume of the society will be relatively less, for the propensity to consume of the rich people is less than that of the poor people.

Elasticity is a measure of a variable's sensitivity to a change in another variable. In business and economics, **elasticity** refers the degree to which individuals, consumers or producers change their demand or the amount supplied in response to price or income changes.

How Elasticity Works

When the value of elasticity is greater than 1, it suggests that the demand for the good or service is affected by the price. A value that is less than 1 suggests that the demand is insensitive to price.

Elasticity is an economic concept used to measure the change in the aggregate quantity demanded for a good or service in relation to price movements of that good or service. A product is considered to be elastic if the quantity demand of the product changes drastically when its

price increases or decreases. Conversely, a product is considered to be inelastic if the quantity demanded of the product changes very little when its price fluctuates.

For example, insulin is a product that is highly inelastic. For diabetics who need insulin, the demand is so great that price increases have very little effect on the quantity demanded. Price decreases also do not affect the quantity demanded; most of those who need insulin aren't holding out for a lower price and are already making purchases.

On the other side of the equation are highly elastic products. Bouncy balls, for example, are highly elastic in that they aren't a necessary good, and consumers will only decide to make a purchase if the price is low. Therefore, if the price of bouncy balls increases, the quantity demanded will greatly decrease, and if the price decreases, the quantity demanded will increase.

Elasticity can be calculated using the following formula:

$$\text{Elasticity} = \frac{\% \text{ change in quantity}}{\% \text{ change in price}}$$

Law of Returns to Scale : Definition, Explanation and Its Types!

In the long run all factors of production are variable. No factor is fixed. Accordingly, the scale of production can be changed by changing the quantity of all factors of production.

Definition:

“The term returns to scale refers to the changes in output as all factors change by the same proportion.” Koutsoyiannis

“Returns to scale relates to the behaviour of total output as all inputs are varied and is a long run concept”. Leibhafskey

Returns to scale are of the following three types:

1. Increasing Returns to scale.
2. Constant Returns to Scale
3. Diminishing Returns to Scale

Explanation:

In the long run, output can be increased by increasing all factors in the same proportion. Generally, laws of returns to scale refer to an increase in output due to increase in all factors in the same proportion. Such an increase is called returns to scale.

Suppose, initially production function is as follows:

$$P = f(L, K)$$

Now, if both the factors of production i.e., labour and capital are increased in same proportion i.e., x, product function will be rewritten as.

$$P_1 = f(xL, xK)$$

1. If P_1 increases in the same proportion as the increase in factors of production i.e., $\frac{P_1}{P} = x$, it will be constant returns to scale.

2. If P_1 increases less than proportionate increase in the factors of production i.e., $\frac{P_1}{P} < x$, it will be diminishing returns to scale.

3. If P_1 increases more than proportionate increase in the factors of production, i.e., $\frac{P_1}{P} > x$, it will be increasing returns to scale. Returns to scale can be shown with the help of table 8.

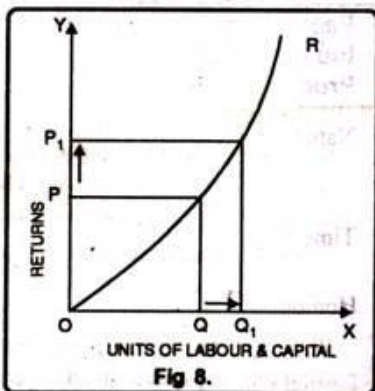
Table 8. Showing different stages of return to scale

| Units of Labour | Units of capital | %age increase in Labour & Capital | Total Product | %age increase in TP | Returns to scale |
|-----------------|------------------|-----------------------------------|---------------|---------------------|------------------|
| 1 | 3 | — | 10 | — | Increasing |
| 2 | 9 | 100% | 30 | 200% | |
| 3 | 9 | 50% | 60 | 100% | |
| 4 | 12 | 33% | 80 | 33% | Constant |
| 5 | 15 | 25% | 100 | 25% | |
| 6 | 18 | 20% | 120 | 10% | Decreasing |
| 7 | 21 | 16.6% | 130 | 8.3% | |

The above stated table explains the following three stages of returns to scale:

1. Increasing Returns to Scale:

Increasing returns to scale or diminishing cost refers to a situation when all factors of production are increased, output increases at a higher rate. It means if all inputs are doubled, output will also increase at the faster rate than double. Hence, it is said to be increasing returns to scale. This increase is due to many reasons like division external economies of scale. Increasing returns to scale can be illustrated with the help of a diagram 8.

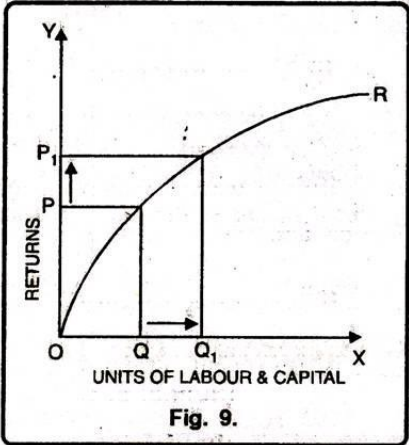


In figure 8, OX axis represents increase in labour and capital while OY axis shows increase in output. When labour and capital increases from Q to Q₁, output also increases from P to P₁ which is higher than the factors of production i.e. labour and capital.

2. Diminishing Returns to Scale:

Diminishing returns or increasing costs refer to that production situation, where if all the factors of production are increased in a given proportion, output increases in a smaller proportion. It means, if inputs are doubled, output will be less than doubled. If 20 percent increase in labour and capital is followed by 10 percent increase in output, then it is an instance of diminishing returns to scale.

The main cause of the operation of diminishing returns to scale is that internal and external economies are less than internal and external diseconomies. It is clear from diagram 9.

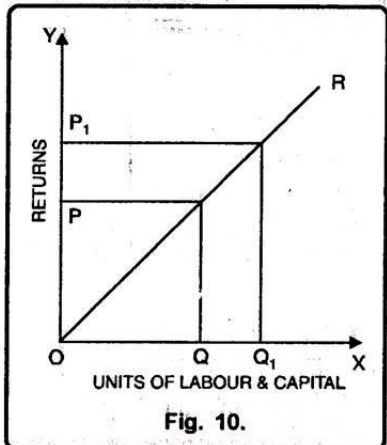


In this diagram 9, diminishing returns to scale has been shown. On OX axis, labour and capital are given while on OY axis, output. When factors of production increase from Q to Q₁ (more quantity) but as a result increase in output, i.e. P to P₁ is less. We see that increase in factors of production is more and increase in production is comparatively less, thus diminishing returns to scale apply.

3. Constant Returns to Scale:

Constant returns to scale or constant cost refers to the production situation in which output increases exactly in the same proportion in which factors of production are increased. In simple terms, if factors of production are doubled output will also be doubled.

In this case internal and external economies are exactly equal to internal and external diseconomies. This situation arises when after reaching a certain level of production, economies of scale are balanced by diseconomies of scale.



UNIT II

Cost and revenue – (concepts only) – price determination under perfect, monopoly and monopolistic competition (concepts and equilibrium only) – concepts and measurement of national income – its importance – business cycle – its feature and phases – measures to reduce the evil effect inflation – effects – anti inflationary measures

Concepts of Cost and Revenue

For producing the Output, the firm needs to employ inputs. But a particular level of output has many ways in which it can be reproduced. There can be one or more input combinations with which a firm can get a desired level of output. But the question is which input combination should the firm choose? With the input prices given, it will choose that combination of inputs which is least expensive and gives max revenue. Thus, for every level of the output, the firm chooses the input combination that includes the least cost. This output-cost relationship of the firm is the cost function.

COSTS

In the short run, a number of the factors of production can not be varied, and so, remain fixed. The cost that a firm incurs to use these mounted inputs is termed the full charge (TFC). Whatever the quantity of output the firm produces, this value remains mounted for the firm. To produce any needed level of output, the firm, within the short run, will alter solely variable inputs.

Accordingly, the value of that a firm incurs to use these variable inputs is termed the full variable cost (TVC).

Adding the mounted and therefore the variable prices, we have a tendency to get the full value (TC) of a firm

$$TC = TVC + TFC$$

In order to extend the assembly of output, the firm must use a lot of of the variable inputs. As a result, the total variable value and total value can increase.

Therefore, as the output will increase, total variable value and total increase.

In the table below, there is an example of the cost function of a typical firm. The first column shows different levels of output.

For all levels of output, the total fixed cost is Rs 20.

Total variable cost increases as output increases. With output zero, TVC is zero.

For one unit of output, TVC is Rs 10; for 2 units of output, TVC is Rs 18 and so on.

In the fourth column, we obtain the total cost (TC) as the sum of the corresponding values in the second column (TFC) and third column (TVC).

At zero level of output, TC is just the fixed cost, and hence, equal to Rs 20. For 1 unit of output, the total cost is Rs 30; for 2 units of output, the TC is Rs 38 and so on.

The short-run average cost (SAC) incurred by the firm is outlined because of the total cost per unit of output. We calculate it as

$$\text{SAC} = \text{TC} / \text{q}.$$

In Table below, we get the SAC-column by dividing the values of the fourth column by the corresponding values of the first column. At zero output, SAC is undefined.

For the primary unit, SAC is Rs 30; for two units of output, SAC is Rs nineteen and then on.

Similarly, the common variable value (AVC) is outlined because of the total variable value per unit of output. We calculate it as

$$\text{AVC} = \text{TVC} / \text{q}$$

Also, average fixed cost (AFC) is

$$\text{AFC} = \text{TFC} / \text{q}$$

Clearly,

$$\text{SAC} = \text{AVC} + \text{AFC}.$$

In Table below, we get the AFC-column by dividing the values of the second column by the corresponding values of the first column.

Similarly, we have a tendency to get the AVC-column by dividing the values of the third column by the corresponding values of the primary column. At zero level of output, each AFC and AVC square measure undefined. For the primary unit of output, AFC is Rs twenty and AVC is Rs ten. Adding them, we have a tendency to get the SAC adequate Rs 30.

The short-run marginal cost (SMC) is defined as the change in total cost per unit of change in output $\text{SMC} = \frac{\text{change in total cost}}{\text{change in output}}$ where Δ represents the change of the variable.

If output changes in distinct units, we may define the marginal cost in the following way.

Let the cost of production for q_1 units and $q_1 - 1$ unit of output be Rs 20 and Rs 15 respectively. Then the marginal cost that the firm incurs for producing q_1 th unit of output is

$$\begin{aligned} \text{MC} &= (\text{TC at } q_1) - (\text{TC at } q_1 - 1) \\ &= \text{Rs } 20 - \text{Rs } 15 = \text{Rs } 5 \end{aligned}$$

Just like the case of marginal product, monetary value is also undefined at zero levels of output.

It is necessary to notice here that within the short run, the fixed cost cannot be changed.

When we change the level of output, whatever change occurs to total cost is entirely due to the change in total variable cost. So in the short run:

| Output Unit[Rs] | tfc | tvc | tc | afc | Avc | Sac | smc |
|--------------------|-----|-----|----|-----|-----|-----|-----|
| 0 | 20 | 0 | 20 | — | — | — | — |
| 1 | 20 | 10 | 30 | 20 | 10 | 30 | 10 |
| 2 | 20 | 18 | 38 | 10 | 9 | 19 | 8 |

| | | | | | | | |
|----|----|----|-----|------|------|-------|----|
| 3 | 20 | 24 | 44 | 6.67 | 8 | 14.67 | 6 |
| 4 | 20 | 29 | 49 | 5 | 7.25 | 12.25 | 5 |
| 5 | 20 | 33 | 53 | 4 | 6.6 | 10.6 | 4 |
| 6 | 20 | 39 | 59 | 3.33 | 6.5 | 9.83 | 6 |
| 7 | 20 | 47 | 67 | 2.86 | 6.7 | 9.57 | 8 |
| 8 | 20 | 60 | 80 | 2.5 | 7.5 | 10 | 13 |
| 9 | 20 | 75 | 95 | 2.22 | 8.33 | 10.55 | 15 |
| 10 | 20 | 95 | 115 | 2 | 9.5 | 11.5 | 20 |

Various Concepts of Costs, Production, and Costs run, marginal cost is the increase in TVC due to increase in production of one extra unit of output.

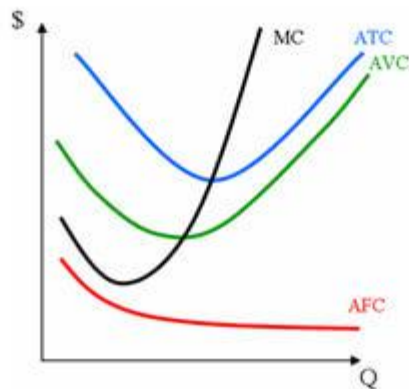
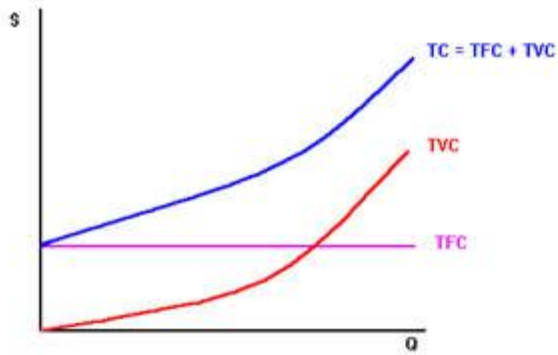
For any level of output, the sum of marginal costs up to that level gives us the total variable cost at that level. One might need to examine this from the instance represented through Table. Average variable value at some level of output is so, the average of all marginal costs up to that level.

In Table above, we see that when the output is zero, SMC is undefined.

For the primary unit of output, SMC is Rs 10; for the second unit, the SMC is Rs eight and then on.

Shapes of the Short Run Cost Curves

Now let us see what these short-run cost curves look like in the output cost plane. We know that in order to increase the production of output the firm needs to employ more of the variable inputs. This results in an increase in total variable cost, and hence, an increase in total cost.



Therefore, as output increases, total variable cost and total cost increase. Total fixed cost, however, is independent of the amount of output produced and remains constant for all levels of production. The shapes of total fixed cost, total variable cost, and total cost curves for a typical firm are as follows: TFC is a constant which takes the value c_1 and does not change with the change in output. It is, therefore, a horizontal straight line cutting the cost axis at the point c_1 . TFC is constant. Therefore, as q increases, AFC decreases. When an output is very close to zero, AFC is arbitrarily large, and as output moves towards infinity, AFC moves towards zero. AFC curve is, in fact, a rectangular hyperbola. If we multiply any value q of output with its corresponding AFC, we always get a constant, namely TFC. The shape of the average fixed cost curve for a typical firm. We measure output along the horizontal axis and AFC along the vertical axis. At q_1 level of output, we get the corresponding average fixed cost at F . The TFC can be calculated as

$$\text{TFC} = \text{AFC} \times \text{quantity}$$

= the area of the rectangle

REVENUE

Revenue in simple word means profit or the sale proceeding are known as revenue. Revenue is of 3 types:

- Total revenue
- Average revenue
- Marginal revenue

Total Revenue

This is simple. The Total Revenue of a firm is the amount received from the sale of the output. Therefore, the total revenue depends on the price per unit of output and the number of units sold. Hence, we have

$$TR = Q \times P$$

Where,

- TR – Total Revenue
- Q – Quantity of sale (units sold)
- P – Price per unit of output

Average Revenue

Average Revenue, as the name suggests, is the revenue that a firm earns per unit of output sold. Therefore, you can get the average revenue when you divide the total revenue with the total units sold. Hence, we have,

$$AR = TR/Q$$

Where,

- AR – Average Revenue
- TR – Total Revenue
- Q – Total units sold

Marginal Revenue

Marginal Revenue is the amount of money that a firm receives from the sale of an additional unit. In other words, it is the additional revenue that a firm receives when an additional unit is sold. Hence, we have

$$MR = TR_n - TR_{n-1}$$

$$MR = \Delta TR / \Delta Q$$

Where,

- MR – Marginal Revenue
- ΔTR – Change in the Total revenue
- ΔQ – Change in the units sold
- TR_n – Total Revenue of n units
- TR_{n-1} – Total Revenue of n-1 units

MR pertains to a change in TR only on account of the last unit sold. On the other hand, AR is based on all the units that the firm sells. Therefore, even a small change in AR causes a much bigger change in MR. In fact, when AR reduces; MR reduces by a far greater margin.

Similarly, when AR increases, MR increases by a greater extent too. AR and MR are equal only when AR is constant. It is also important to note that the firm does not sell any unit if the TR or AR becomes either zero or negative. However, there are times when the MR is negative (especially if they fall in price is big).

The Relationship between TR, AR, and MR

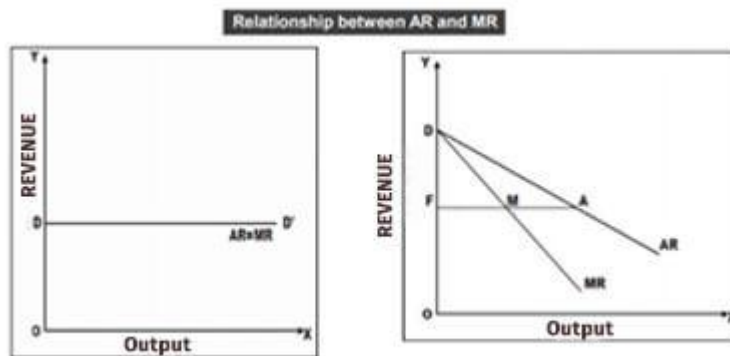
In order to understand the basic concepts of revenue, it is also important to pay attention to the relationship between TR, AR, and MR. when the first unit is sold, TR, AR, and MR are equal.

Therefore, all three curves start from the same point. Further, as long as MR is positive, the TR curve slopes upwards.

However, if MR is falling with the increase in the quantity of sale, then the TR curve will gain height at a decreasing rate. When the MR curve touches the X-axis, the TR curve reaches its maximum height.

Further, if the MR curve goes below the X-axis, the TR curve starts sloping downwards. Any change in AR causes a much bigger change in MR. Therefore, if the AR curve has a negative slope, then the MR curve has a greater slope and lies below it. Similarly, if the AR curve has a positive slope, then the MR curve again has a greater slope and lies above it. If the AR curve is parallel to the X-axis, then the MR curve coincides with it.

Here is a graphical representation of the relationship between AR and MR:



In the left half, you can see that AR has a constant value (DD'). Therefore, the AR curve starts from point D and runs parallel to the X-axis. Also, since AR is constant, MR is equal to AR and the two curves coincide with each other.

In the right half, you can see that the AR curve starts from point D on the Y-axis and is a straight line with a negative slope. This basically means that as the number of goods sold increases, the price per unit falls at a steady rate.

Similarly, the MR curve also starts from point D and is a straight line as well. However, it is a locus of all the points which bisect the perpendicular distance between the AR curve and the Y-axis. In the figure above, $FM=MA$.

Determination of Price Under Perfect Competition!

Earlier economists took one sided view of the problem of price determination. It was only Dr. Marshall who gave equal importance to demand and supply.

He pointed out that it was useless to argue whether it was demand curve or it was supply curve which was more important.

He pointed out that a market is composed of two parties, viz. the buyers and the sellers and both of them are equally important. In the absence of anyone, price cannot be determined.

He, therefore, argued that both buyers and sellers are important in the market and, both demand and supply curves are important for determining the price of a commodity.

Marshall compared the demand curve and the supply curve to the two blades of a 'pair of scissors'. He pointed out that blades are needed to cut cloth. If a person wants to cut with a single blade it will be impossible.

He further stated that at different occasions the upper or the lower blade becomes more or less important. According to him, it is a matter of time that at some moments it is the demand curve and at some other moments it is the supply curve, which is more important.

In the same way, Prof. Stonier and Hague has correctly remarked, "The only really accurate answer to the question whether it is supply or demand which determines price is that it is both." The price which will come to prevail in the market is one at which quantity demanded is equal to quantity supplied. The price at which quantity demanded equals quantity supplied is called equilibrium price.

Factors Affecting Price Determination:

Let us discuss these two factors:

(i) Total Demand:

Demand does not mean the amount of a commodity, say, tea, which people need, or would like to have, but the effective demand, the amount which people are willing to buy at various prices. Every unit of a commodity has a demand price, the price at which that unit finds a buyer.

Other things being equal, a fall in price leads to an increase in quantity demanded and rise in price leads to reduction in quantity demanded. A fall in the price induces the existing buyers to buy more and attracts new customers. It may also have substitution and income effects. The quantity demanded thus varies with every change in price.

(ii) Total Supply:

Supply means the quantity offered for sale by producers. Thus the supply of tea does not mean the actual stock of tea; it means the amount of tea which the producers are willing to put on the market at various prices.

Every unit of a commodity has a supply price-the price at which it is offered for sale. Other things being equal, a rise in price leads to an increase in the quantity offered for sale, and a fall in price reduces the quantity offered for sale.

Equilibrium between Demand & Supply Prices:

Equilibrium between demand & supply price is obtained by the interaction of these two forces.

It is being discussed with the help of a table 1 and a diagram 1 below:

Table 1
Equilibrium between Demand and Supply

| Price | Demand | Supply | Pressure on price |
|-------|--------|--------|-------------------|
| 5 | 12 | 1 | |
| 10 | 10 | 2 | D > S |
| 15 | 8 | 4 | Excess Demand |
| 20 | 6 | 6 | D = S |
| 25 | 4 | 8 | Equilibrium |
| 30 | 2 | 10 | D < S |
| 35 | 1 | 12 | Excess Supply |

In the table 1, at price Rs. 20 the quantity demanded and quantity supplied are equal to each other. Thus, the price Rs. 20 will be settled down in the market where both the buyers and sellers are satisfied. Once this equilibrium price prevails in the market, there will be no tendency for it to change.

Now, suppose the price is Rs. 25 in the market, the buyers would demand only four units while the sellers are ready to supply 8 units. For this the sellers will compete with each other to sell more units of the commodity.

This process will continue, till the equilibrium price is reached. On the other hand, if the price falls below the equilibrium level say Rs. 15 the buyers will demand 8 units and the sellers will be ready to supply 4 units.

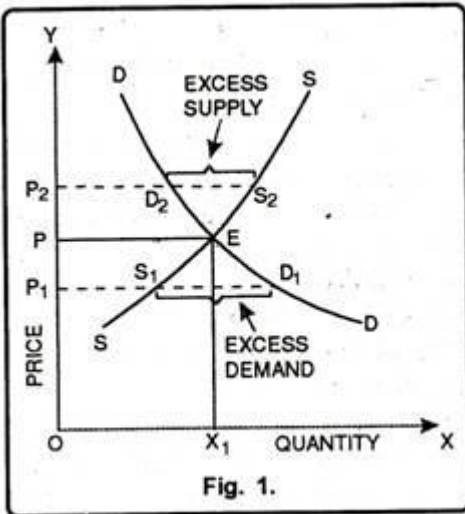
Diagrammatic Representation:

In figure 1, DD is the demand curve, SS is the supply curve. Demand and supply are in equilibrium at point E where both curves intersect each other.

Here, equilibrium output is OX_1 and price is OP. Now, suppose the price is greater than equilibrium price i.e. OP_2 . At this price quantity demanded is P_2D_2 , while the quantity supplied is P_2S_2 . Thus, D_2S_2 is the excess supply which the buyers will not take off the market at price OP_2 .

In order to dispose of the said excess supply, the seller will compete with each other and will bring down the price.

Hence, the price will fall to the level of OP. At price OP_1 the buyers will demand P_1D_1 while the sellers are prepared to supply P_1S_1 . In this way, unsatisfied buyers will compete with each other to have the limited supply. Therefore, there will be tendency for the price to rise to the level of OP.

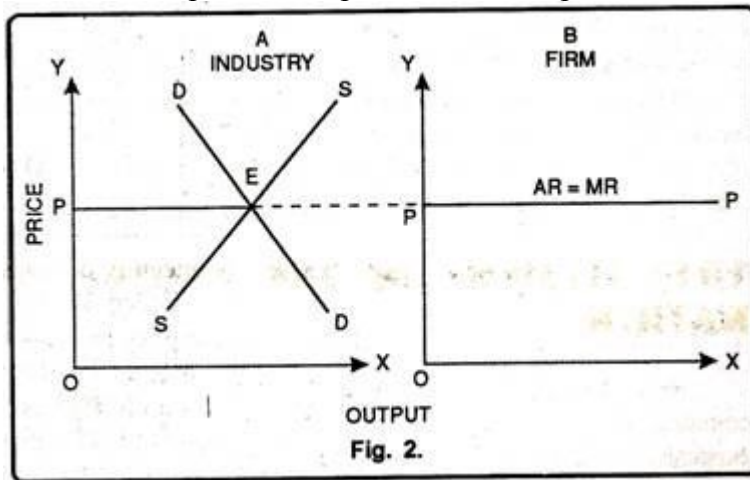


Equilibrium Price of Firm and Industry:

Prices under perfect competition are determined by industry and each firm will have to follow this price. It can be shown with the help of fig. 2.

In Fig. 2A demand curve DD cuts the industry supply curve SS at point E. Thus, E is the equilibrium point which determines OP as an equilibrium price. Fig. 2B reflects the firms demand curve. The firm will have to sell all its output at OP price.

The firm cannot increase or decrease their price as it is determined by industry. It is so because under perfect competition firm is a price taker and not a price maker.



Changes in Equilibrium:

The equilibrium price and quantity will change as a result of shift either in demand curve or supply curve or both.

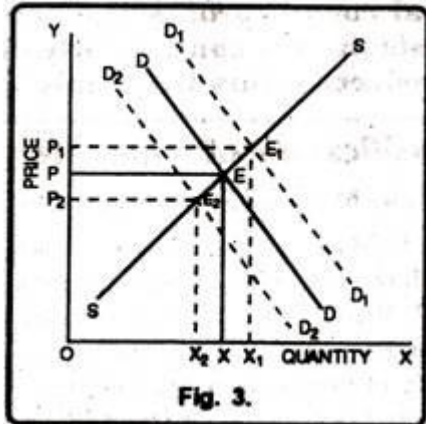
It can be shown as follows:

(i) Effect of Shift in Demand:

Demand changes whenever there is a change in the conditions of demand- income, tastes, prices of substitutes and complements etc. If demand increases due to a change in any one of these conditions the demand curve moves upward to the right. If, on the other hand, demand decreases, the demand curve moves downward to the left. Let us consider the effects of changes in demand on price increases (i.e., at the old price a greater quantity is demanded) price and quantity demanded both increase.

Let us show the effect of a change in demand on price and quantity. Given the supply curve, an upward shift in the demand curve causes the price to rise. A downward shift of the demand curve causes the price to fall.

This is shown in the figure given below:

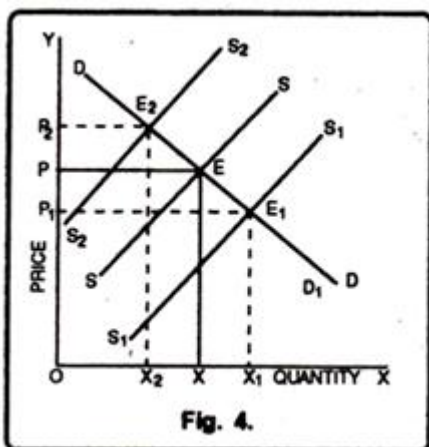


In figure 3 Quantity demanded and supplied is shown on X-axis whereas price on Y-axis. DD is the original demand curve. Initially, the demand and supply curves intersect each other at point E. Thus, OP is the equilibrium price and OX is the equilibrium quantity demanded.

Now, suppose the demand increases and takes the form of $D_1 D_1$. The new demand curve intersects the supply curve at point E_1 , where the quantity demanded goes to OX_1 and price at OP_1 . In the same way, if the demand curve shifts downward and assumes the form $D_2 D_2$, the equilibrium will be at point E_2 and, therefore, quantity demanded will be OX_2 and price is OP_2 . Thus, we conclude that if the supply conditions are given then there is direct relation between demand and price.

(ii) Effect of Shift in Supply:

We shall consider the effects of changes in supply on price assuming that demand remains unchanged. An increase in supply is represented by a shift of the supply curve to the right (or downward) and a decrease in supply is represented by a shift to the left or upward. The general rule is: if the supply increases, price falls and if supply decreases price rises.



In figure 4 both the demand and supply curves intersect each other at point E. Thus, OP is the equilibrium price and OX is the equilibrium quantity. Now, supply curve shifts from SS to $S_1 S_1$ — At this level quantity demanded increases form OX to OX_1 but the price falls from OP to OP_1 .

Similarly, if the supply curve takes the form of S_2S_2 instead of SS , that way quantity demanded falls to OX_2 while the price increases from OP to OP_2 — Here; we may observe that there is inverse correlation between quantity demanded and price.

A Monopoly market is characterized by a single producer and seller of a product with no substitutes. This indicates that the monopolist faces a downward-sloping demand curve and can choose the price at which its product sells. There are high barriers to entry for a new firm in a monopoly.

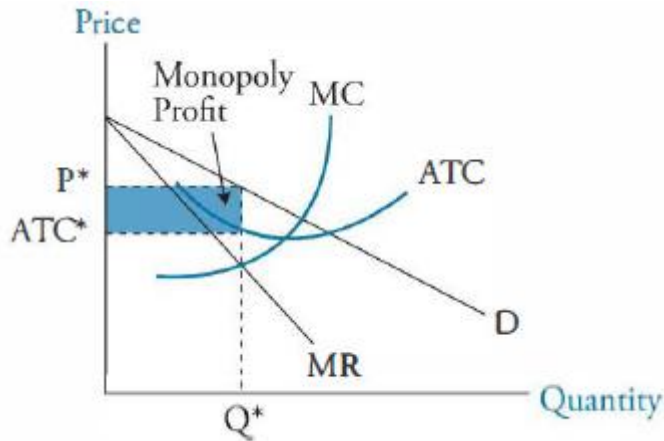
The Monopolistic competition differs from perfect competition in that products are not identical. Each firm differentiates its products from those of other firms through some combination of differences in product quality, product features, and marketing. Firms in the monopolistic competition face downward-sloping demand curves but the demand is not perfectly elastic. A monopoly at the other extreme is characterized by only one firm producing the product. In between are monopolistic competition (multiple firms with differentiated products) and oligopoly (few firms competing in various ways).

Let us study much more about Monopoly vs Monopolistic in detail:

Basically, there exist 4 different market structures in any economy or country. Monopoly vs Monopolistic competition can be differentiated in terms of the number of firms and their relative sizes, the elasticity of demand curves that they face, ways that they compete with other firms for sales and ease/difficulty with which firms can either enter/exit the market. Perfect competition, at one end of the spectrum, consists of many firms that produce identical products and hence forces all firms to sell at the same market price. Monopoly firms' source of power comes from elements such as copyrights or patents. Control over a resource needed specifically to make the product could be another source of power for a monopoly firm. More often than not, monopoly power is supported by the government. Monopolists are price searchers as they have imperfect information regarding market demand. They must experiment with different prices to find the one that maximizes profit.

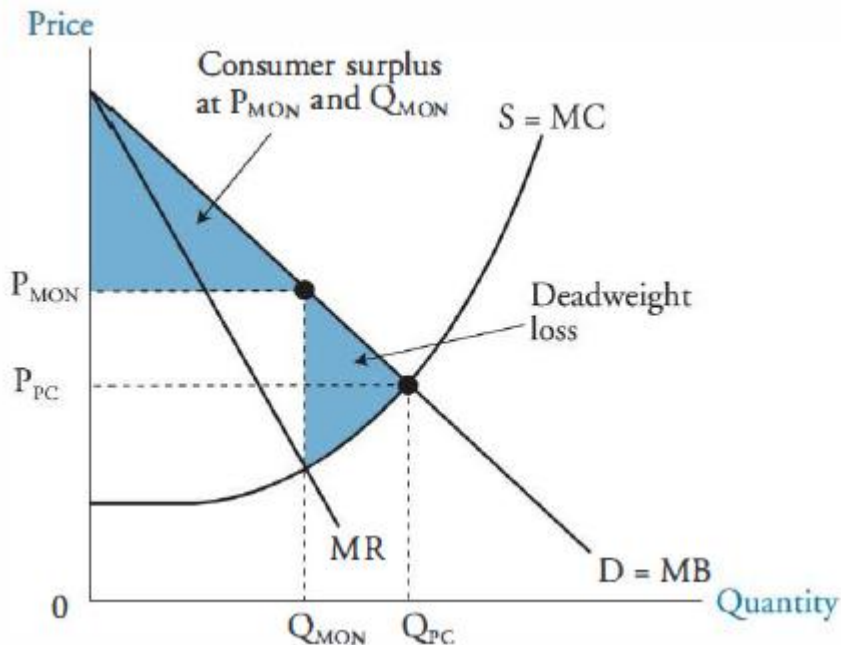
Figure 1 illustrates the revenues and cost structure for a monopolist. Note that production will expand till Marginal Revenue (MR) = Marginal costs (MC) at optimal output Q^* . The price at which the product will sell is in a demand curve which is P^* . In perfect competition, the profit-maximizing output is when $MR = MC$ which is the same for the monopolist. To ensure a profit, the demand curve must lie above the firm's Average Total Cost (ATC) at the optimal quantity so that price $> ATC$. Monopoly profit is ensured when the demand curve lies above the firm's Average Total Cost (ATC) at the optimal quantity which is characterized by price $P^* > ATC$.

Figure 1 – Monopoly short-run costs and revenues[1]



Further Figure 2 illustrates the concept of deadweight loss and difference in allocative efficiency in perfect competition and a monopoly. As depicted in the figure, S , the industry supply curve, indicates the summation of all supply curves of the firms competing in the market. The quantity Q_{PC} and equilibrium price P_{PC} in a perfect competition lie at the intersection of the industry supply curve and the market demand curve, D . Each firm is smaller in comparison to the overall industry and hence there is no gain to be achieved by attempting to increase the price by decreasing output. A monopolist on the other hand facing the same demand and marginal cost curve, will produce Q_{MON} and ensure a maximum profit by charging a price of P_{MON} . A deadweight loss is created as monopolists produce a quantity that does not ensure the maximization of the sum of consumer surplus and producer surplus.

Figure 2 – Perfect Competition vs Monopoly[2]



In perfect competition, the products by the firms are perfectly identical. The market of toothpaste is an excellent example of firms in monopolistic competition. Firms vie for customers by differentiating their products through features and marketing such as claims of fresher breath or whiter teeth or more attractive teeth or prevention of decay. If the price of your favorite

product increases one is not immediately likely to switch to another brand as would have happened in perfect competition. Some customers would switch in response to a 10% increase in price and some would not.

Figure 3(a) illustrates the short-run price/output characteristics of monopolistic competition for a single firm. Firms maximize profits by producing where $MR = MC$. Here firm earns positive economic profits because the price, P^* , exceeds Average Total Cost, ATC^* . Due to low barriers to entry, companies will enter the market in pursuit of these economic profits. Figure 3(b) illustrates when new firms enter the market and it shifts the demand curve faced by each individual firm down to the point where Price P^* equals Average Total Cost ATC^* such that economic profit is zero. At this point, there is no longer an incentive for new firms to enter the market and a long run equilibrium is established.

Figure 3 – Short and Long-run output in Monopolistic competition[3]

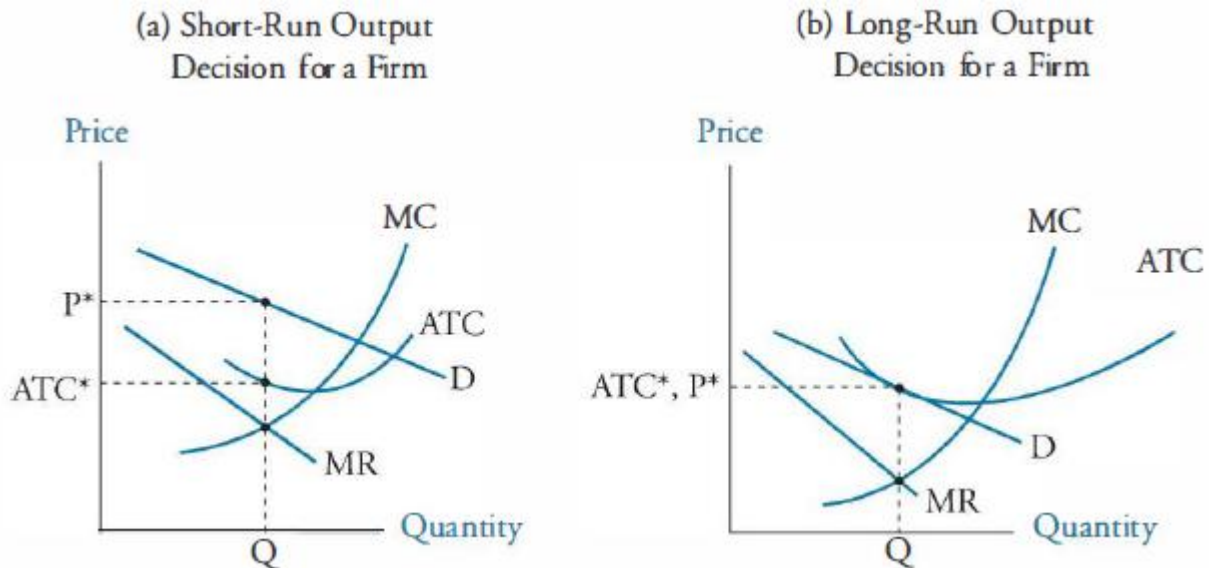
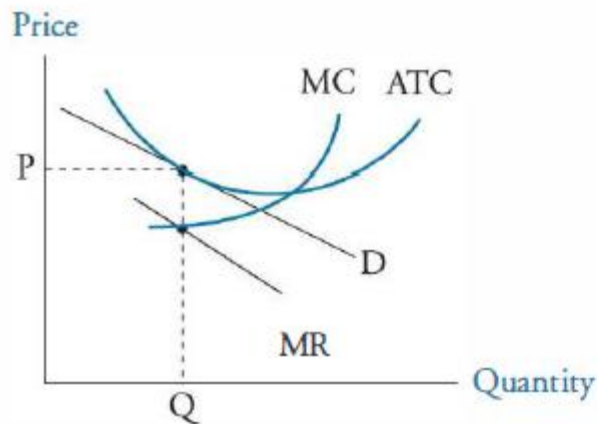


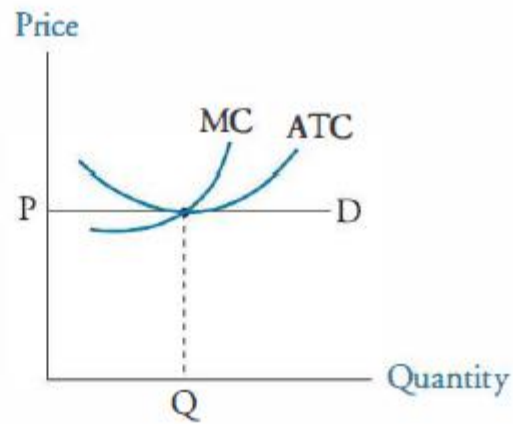
Figure 4 illustrates the differences between long-run equilibrium in monopolistic and perfect competition. In monopolistic competition, the price is greater than marginal cost i.e. producers can realize a markup and average total cost is not at a minimum for the quantity produced suggesting there is an excess capacity or an inefficient scale of production and the price is slightly higher than the perfect competition. The point to be noted here is that perfect competition is characterized by no product differentiation.

Figure 4 – Monopolistic competition vs Perfect Competition[4]

(a) Monopolistic Competition



(b) Perfect Competition



Meaning and Definition of National Income or National Dividend:

The total income of the nation is called national income. In real terms, national income is the flow of goods and services produced in the economy in a particular period—a year.

Modern economy is a money economy. Thus, national income of the country is expressed in money terms.

A National Sample Survey has therefore defined national income as **“The money measures of the net aggregate of all commodities and services accruing to the inhabitants of community during a specific period.”**

In other words we can say that national income is a money measure or value of net aggregate of goods and services becoming available annually to the nation as a result of the economic activities of the community at large consisting of households or individuals, business firms and social and political institutions. The time is accepted as one year all over the world as it is concerned with the natural and seasonal factors. In one year all the seasons repeat itself. Thus, all the definitions and National Income consider one year.

Definitions:

The definitions of national income can be grouped into two classes:

1. The traditional definitions advanced by Marshall, Pigou and Fisher.
2. Modern definition given by Prof. Simon Kuznet.

The Marshallian Definition:

According to Marshall—“The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial including services of all kinds. This is the true net annual income or revenue of the country or national dividend.” In this definition, the word **“net”** refers to deductions from the gross national income in respect of depreciation of capital equipment used in the creation of productive activity. And to this must be added income from abroad.

Other features of this definition are:

- (i) It is measured on one year basis,
- (ii) It includes the values of goods and services,
- (iii) It includes only those things which are produced by labour and capital of a country with the help of the natural resources,
- (iv) It excludes the depreciation and debasement of capital goods,

- (v) It includes the net foreign investment in the country,
- (vi) It excludes all those goods and services which are produced by friends, relatives or organisations free of costs.

No doubt Prof. Marshall's definition is theoretically sound, simple and comprehensive but it has got some serious practical limitations:

- (i) It is not easy to ascertain or make statistically correct estimate of the total production of goods and services in an economy,
- (ii) The problem of double counting has been ignored,
- (iii) How to make allowance for the portion of the produce kept for self-consumption,
- (iv) The problem of current and base year prices is also ignored.

The Pigovian Definition:

Marshall's follower, A. C. Pigou has in his definition of national income included that income which can be measured in terms of money. In the words of Pigou—"National income or National Dividend is that part of objective income of the community including of course income derived from abroad which can be measured in money."

This definition is better than the Marshallian definition. It has proved to be more practical also. The above definition of Prof. Pigou is classificatory; it takes into account of those goods and services which can be measured by the measuring rod of money.

All those goods which are given as gifts, bounties etc. are not included in the national income, Prof. Pigou's definition is used in exchange economy where goods and services are exchanged for money only, The definition takes into account the net value of goods and services which are exported and imported.

Fisher's Definition:

Fisher picked up in his study 'Consumption' as the criterion of national income whereas Marshall and Pigou regarded it to be 'production'. According to Fisher—"The national dividend or income consists solely of services as received by ultimate consumers, whether from their material or from the human environments. Thus, a piano, or an overcoat made for me this year is not a part of this year's income, but an addition to the capital, only the services rendered to me during this year by these things are income."

Fisher's definition has been considered as better than that of Marshall or Pigou because Fisher's definition provides an adequate concept of economic welfare which is dependent on consumption and consumption represents our standard of living.

Prof. Simon Kuznet's Definition:

Prof. Simon Kuznets was an expert advisor to the National Income Estimate Committee of India in 1949. He has the practical experience of estimating National Income in India and U.S.A. His view was that the concept of national income may be simple from theoretical point of view whereas most difficult from the practical point of view.

He has defined national income in practical prospective as:

"The Net Output of Commodities and Services flowing in a year from the country's productive system in the hands of ultimate consumers or into net addition to the country's capital goods. In practical life, while estimating national income any of these four definitions may be adopted, because the same national income would be derived, if different it's were correctly included in the estimate.

The salient features of its being best as given as under:

- (i) It is the net aggregate of goods and services,
 - (ii) Only those goods and services are taken into consideration which are produced by the productive system of an economy,
 - (iii) The period of production is taken as one year,
 - (iv) In order to avoid the problem of double counting only those goods are considered as product which either go into the hands of ultimate consumers or used by the productive system as capital goods,
 - (v) National income is considered as flow of goods and services. The flow is a continuous one.
- But this definition takes into consideration only domestic income and ignores the concept of net income earned from abroad. Further, in the estimation of national income the concept of ultimate consumer is ignored. We normally undertake that value of goods which we get in exchange for commodity.

Different Concepts of National Income:

In the measurement of national income there are various situations which we will have to study and they are known as concepts of national income. These concepts have their significance in national income accounting.

Important concepts have been discussed here under:

1. Gross National Income or Product (GNP):

Gross National Product has been defined as the total market value of all final goods and services produced in a year. It is the money value of all the final goods and services which the labour and capital of a country working on its natural resources have produced in a year. It includes not only the part of the production which is brought to the market for sale but also that part of the produce which is kept for self consumption.

While estimating Gross National Product a care is taken that no commodity is counted more than once. For this, only the value of the final goods and services produced or value added by each producer is included in the Gross National Product.

Factors to be taken into consideration while studying Gross National Product:

- (i) As GNP is the measure of money, so all kinds of goods and services produced in a country during one year are measured in terms of money at current prices and then added together.
- (ii) In estimating GNP of the economy, the market price of only the final products should be taken into account. Many of the products pass through a number of stages before they are ultimately purchased by consumers.
- (iii) Goods and services rendered free of charge are not included in the GNP, because it is not possible to have a correct estimate of their market prices.
- (iv) The transactions which do not arise from the produce of current year or which do not contribute in any way to production are not included in the GNP. The sale and purchase of old goods and of shares, bonds are assets of existing companies are not included in GNP because they do not make any addition to the national product and the goods are simply transferred.
- (v) The profits earned or losses incurred on account of changes in capital assets as a result of fluctuations in market prices are not included in the GNP if they are not responsible for current production or economic activity.
- (vi) The income earned through illegal activities is not included in the GNP. Although the goods sold in the black-market are priced and fulfill the needs of the people, but as they are not useful

from the social point of view, the income received from their sale and purchase is always excluded from the GNP.

2. Net National Product or (NNP):

Net National Product (NNP) refers to the value of the net output of the economy during the year. It is obtained by deducting the value of depreciation or replacement allowance of the capital assets from the GNP.

To put it symbolically:

$$\text{NNP} = \text{GNP} - \text{D}$$

where D = depreciation allowances.

This value is measured at current prices, while GNP is expressed at the current market price. Net National Product, in-fact, is the value of total consumption plus the value of net investment of the community. It is the sum total of net values added by each producer in the productive process of an economy during one year period.

3. Gross Domestic Product (GDP):

Gross Domestic Product is the money value of all goods and services produced annually within the territorial limits of the country.

Gross Domestic Income includes:

- (i) Wages and salaries,
- (ii) Rents, including imputed house rents,
- (iii) Interest,
- (iv) Dividends,
- (v) Undistributed corporate profits, including surpluses of public undertakings,
- (vi) Mixed incomes consisting of profits of unincorporated firms, self-employed persons, partnership etc., and
- (vii) Direct taxes.

In the estimation of Gross Domestic Product, no consideration is given to the fact as to whether the gross value of produce is with the combined efforts of only the people of the country with the co-operation of the foreigners. But the product must be produced in the country alone as the net earnings from abroad are excluded.

Therefore, Domestic Income = National Income – Net Income earned from abroad.

Thus, the difference between domestic income and national income is the net income earned from abroad. If we add net income from abroad to domestic income, we get national income.

i.e., National Income = Domestic Income + Net Income earned from abroad.

But the net national income earned from abroad may be positive or negative.

4. Per Capita Income:

Per capita income refers to the average income of an individual in a particular year. It denotes the income received by an individual during a certain year in a country. In order to find per capita income of a country in a certain year, we divide the national income of that country by the population of that country in that year e.g.,

$$\text{Per-Capita Income} = \frac{\text{National Income of India in 2002}}{\text{Population of India in 2002}}$$

It is clear that a country having high national income and less population will have higher per capita income. The concept of per capita income helps us in estimating the standard of living of different nations and it also serves as an index of economic development.

5. Personal Income:

Personal income is the aggregate income received by the individuals of a country from all sources before payment of direct taxes in one year. It is derived from national income by

deducting undistributed corporate profits, profit taxes and employee's contributions to social security schemes.

These three components are excluded from national income because they do not reach individuals. It can never be equal to the national income, because the former includes the transfer payments whereas they are not included in national income.

Business and Government transfer payments and transfer payments from abroad in the form of gifts and remittances, wind-fall gains and interest on public debts are a source of income for individuals are added to national income. Thus,

Personal Income = National Income + Transfer Payment + Interest on Public Debt – Undistributed Corporate Profits – Profit Taxes — Social Security Contribution.

Personal Income differs from Private Income in that it is less than the latter because it excludes undistributed corporate profits. Thus

Personal Income = Private Income – Undistributed corporate profits – Profit taxes.

6. Disposable Income or Personal Disposable Income:

Disposable income or personal disposable income is the actual income which can be spent on consumption because it is the income that accrues before direct taxes have actually been paid. Therefore, in order to obtain the disposable income, direct taxes are deducted from personal income. Thus,

Disposable Income = Personal Income — Direct Taxes.

But it should be remembered while calculating this income that the whole of the disposable income is not spent on consumption and a part of it is saved. Therefore, the disposable income is divided into consumption expenditure and saving. Thus,

Disposable Income = Consumption Expenditure + Savings

The concept of Disposable Income is very useful in computing the real purchasing power of the country. It also gives us an information regarding the personal consumption pattern. It refers to that part of the personal income which is actually available to the consumers. It can be obtained by deducting the amount of personal taxes, fines etc., from personal income. It is at the disposal of the consumers to save or consume or to use it in any way they like.

Business Cycle

A business cycle is a cycle of fluctuations in the [Gross Domestic Product](#) (GDP) around its long-term natural growth rate. It explains the expansion and contraction in [economic activity](#) that an economy experiences over time.

A business cycle is completed when it goes through a single boom and a single contraction in sequence. The time period to complete this sequence is called the length of the business cycle. A boom is characterized by a period of rapid economic growth whereas a period of relatively stagnated economic growth is a recession. These are measured in terms of the growth of the real GDP, which is [inflation](#) adjusted.

Stages of the Business Cycle

In the diagram above, the straight line in the middle is the steady growth line. The business cycle moves about the line. Below is a more detailed description of each stage in the business cycle:

1 Expansion

The first stage in the business cycle is expansion. In this stage, there is an increase in positive economic indicators such as employment, income, output, wages, profits, demand, and supply of

goods and services. Debtors are generally paying their debts on time, the velocity of the money supply is high, and investment is high. This process continues until economic conditions become favorable for expansion.

2 Peak

The economy then reaches a saturation point, or peak, which is the second stage of the business cycle. The maximum limit of growth is attained. The economic indicators do not grow further and are at their highest. Prices are at their peak. This stage marks the reversal in the trend of economic growth. Consumers tend to restructure their budget at this point.

3 Recession

The recession is the stage that follows the peak phase. The demand for goods and services starts declining rapidly and steadily in this phase. Producers do not notice the decrease in demand instantly and go on producing, which creates a situation of excess supply in the market. Prices tend to fall. All positive economic indicators such as income, output, wages, etc. consequently start to fall.

4 Depression

There is a commensurate rise in unemployment. The growth in the economy continues to decline, and as this falls below the steady growth line, the stage is called depression.

5 Trough

In the depression stage, the economy's growth rate becomes negative. There is further decline until the prices of factors, as well as the demand and supply of goods and services, reach their lowest. The economy eventually reaches the trough. This is the lowest it can go. It is the negative saturation point for an economy. There is extensive depletion of national income and expenditure.

6 Recovery

After this stage, the economy comes to the stage of recovery. In this phase, there is a turnaround from the trough and the economy starts recovering from the negative growth rate. Demand starts to pick up due to the lowest prices and consequently, supply starts reacting, too. The economy develops a positive attitude towards investment and employment and hence, production starts increasing.

Meaning of Inflation:

By inflation we mean a general rise in prices. To be more correct, inflation is a persistent rise in the general price level rather than a once-for-all rise in it.

On the other hand, deflation represents persistently falling prices. Inflation or persistently rising prices is a major problem in India today. When price level rises due to inflation the value of money falls. When there is a persistent rise in price level, the people need more and more money to buy goods and services.

Causes of Inflation:

Let us understand how the inflation originates or what causes it.

Depending upon the specific causes, three types of inflation have been distinguished:

- (1) Demand-pull inflation,
- (2) Cost-push inflation, and
- (3) Structuralist inflation.

An important cause of demand-pull inflation is the excessive growth of money supply in the economy. We will explain this cause of inflation in the Monetarist Theory of Inflation. We will explain and discuss below these three types of inflation.

Demand-Pull Inflation:

This represents a situation where the basic factor at work is the increase in aggregate demand for output either from the households or the entrepreneurs or government organised. The result is that the pressure of demand is such that it cannot be met by the currently available supply of output.

Cost-Push Inflation:

We can visualize situations where even though there is no increase in aggregate demand, prices may still rise. This may happen if there is initial increase in costs independent of any increase in aggregate demand.

The four main autonomous increases in costs which generate cost-push inflation have been suggested:

1. Oil Price Shock
2. Farm Price Shock
3. Import Price Shock
4. Wage-Push Inflation

Cost-Push inflation is also called supply-side inflation:

1. Oil Price Shock:

In the seventies the supply shocks causing increase in marginal cost of production became more prominent in bringing about cost-push inflation. During the seventies, rise in prices of energy inputs (hike in crude oil price made by OPEC resulting in rise in prices of petroleum products). The sharp rise in world oil prices during 1973-75 and again in 1979-80 produced significant supply shocks resulting in cost-push inflation.

2. Farm Price Shock:

Cost-push inflation can also come about from increase in prices of other raw materials, especially farm products, in economies such as that of India where they are of greater importance. In India when monsoon is not adequate or come very late or when weather conditions are quite unfavourable, they reduce the supply of agricultural products and raise their prices.

3. Import Price Shock:

These days currencies of most countries of the world are flexible, that is, determined by demand for and supply of a currency and they can appreciate or depreciate every month in terms of the US dollar. For example, when the Indian rupee depreciates, more rupees are required to buy one US dollar and therefore in terms of rupees, imports become costlier.

4. Wage Push Inflation:

It has been suggested that the growth of powerful trade unions is responsible for the spread of inflation, especially in the industrialized countries. When trade unions push for higher wages which are not justifiable either on grounds of a prior rise in productivity or of cost of living they produce a cost-push effect.

Structuralist Theory of Inflation:

Structuralist theory, another important theory of inflation, is also known as structural theory of inflation and explains inflation in the developing countries in a slightly different way. The Structuralist argue that increase in investment expenditure and the expansion of money supply to finance it are the only proximate and not the ultimate factors responsible for inflation in the developing countries.

The Social Costs and Effects of Inflation:

Having discussed the so called inflation fallacy we proceed to explain in detail the social cost and effects of inflation. Apart from reducing the purchasing power of people's incomes, inflation inflicts some other costs on the society. To explain such costs of inflation it is necessary to distinguish between anticipated inflation and unanticipated (i.e., unexpected) inflation. As noted above, in case of anticipated inflation, the expected rise in price level is taken into account while making economic transactions, for example, in negotiating wage rate of labour etc.

Costs of Anticipated Inflation:

Suppose in an economy there has been annual inflation rate of 5 per cent for a long time in the past and everybody expects that this 5 per cent rate of inflation will continue in the future too. In such a case all contracts made by the people such as loan agreements with borrowers, wage contracts with labour, property lease contracts will provide for 5 per cent annual rise in rates of interest, wages, rent to compensate for inflation of that order.

We explain below both these types of costs:

1. Shoe-leather Costs:

This type of cost occurs because on account of inflation cost of holding money in the form of currency (i.e., notes and coins) rises with the increase in inflation rate. Such cost arises because no interest is paid on holding currency, while money kept in deposits with the bank or used for keeping bonds earns interest.

2. Menu Costs:

The second type of anticipated inflation is menu costs, a term derived from a restaurant's cost of printing a new menu. Menu costs arise because high inflation requires them to change their listed prices more often. Changing prices is somewhat more expensive because the firms have to print new catalogues listing new prices and distribute them among their customers. They have even to incur expenditure on advertisements to inform the public about their new prices.

3. Macroeconomic Inefficiency in Resource Allocation:

A third cost of inflation arises because firms having menu costs change their prices quite infrequently. Given the reluctance to change prices frequently, the higher the rate of inflation, the greater the variability in relative prices of a firm. Suppose a firm issues a new catalogue listing prices of its products once in a year, say in the month of January of every year.

4. Inconvenience of Living:

Lastly, another social cost of inflation is the inconvenience of living in a world with a changing price level. Money is the yardstick with which we measure the value of transactions. When inflation is taking place the value of money changes and as a result it becomes difficult to correctly estimate the value of transactions in real terms every time a transaction is made during a year.

UNIT III

Types of money – function of money – monetary standards – types, merits and demerits –of note issue – currency principle, banking principle – methods of note issue – India's present currency system – monetary policy objectives – its weapons and limitations.

Types of money:

1. Standard Money:

Standard Money is that form of money in terms of which all other forms of money in the country are measured.

It is unlimited legal tender and is subject to free coinage, i.e., anybody can bring his metal and get coins made of it. Usually it's real or 'intrinsic value' is equal to its face value. It is either made of gold or silver, or sometimes both. At present, no country has such a money in Standard Money.

2. Token Money:

Token money is made of cheaper metal; it is limited legal tender; it is not subject to free coinage and its face value is greater than its intrinsic or metallic value. Token money consists of small coins. The rupee is the standard unit of money in India, but its face value is greater today than its real value. Nor is the rupee subject to free coinage. It cannot, therefore, be called standard money. It is a mixture of the standard and token money.

3. Bank Money:

Bank money refers to bank deposits, the bank deposits can be turned into money by their depositors by means of cheques. In advanced countries the cheques are as good as money and circulate as such. Bank money or 'cheque-created money' is, however, quantitatively the most important now in all modern communities.

4. Money of Account:

Money of account is the monetary unit in terms of which the accounts of a country are kept and transactions made, i.e., in which general purchasing power, debts are prices are expressed. The rupee, for instance is our money of account. Sterling, dollar, frank and mark are the moneys of account respectively of Great Britain, the United States, France and West Germany.

5. Coins and Coinage:

Metallic money consists of coins made of gold, silver, nickel, or copper. The coins may be:

(a) Standard coins and

(b) Token coins.

Standard Coins:

The standard coins, as already mentioned, are:

(1) Unlimited legal tender.

(2) Subject to free coinage, and

(3) Have their face value equal to their metallic or intrinsic value

The proportion of pure metal to weight in the coin is spoken of as "so much tme". The Indian rupee was at one time made of silver weighing 180 grains and was 11/12 fine. During the war, new rupee (quaternary coins) were issued ½ fine and in 1947 nickel rupees were issued. The edges of the new rupee were slightly raised to avoid too much wear.

In addition, the edge was milled to avoid clipping or filing. At present, very few rupee coins are found in circulation. They have been replaced by rupee notes. All the world over, the State has the right of issuing coins which are made in a government mint There are mints at Bombay Calcutta in India.

Token Coins:

A coin has value because it is made of a valuable metal. It is full-bodied if its face value is equal to the metal contained in it. Sometimes however, a coin has value only because the

government has stamped it. When the value given to a coin by government is in excess of its contents, it is called a 'token coin'.

Functions of money.

1. A Medium of Exchange:

The only alternative to using money is to go back to the barter system. However, as a system of exchange the barter system would be highly impracticable today. For example, if the baker who supplied the green-grocer with bread had to take payment in onions and carrots, he may either not like these foodstuff or he may have sufficient stocks of them.

2. A Measure of Value:

Under the barter system, it is very difficult to measure the value of goods. For example, a horse may be valued as worth five cows or 100 quintals of wheat, or a Maruti car may be equivalent to 10 two-wheelers. Thus one of the disadvantages of the barter system is that any commodity or service has a series of exchange values.

Money is the measuring rod of everything. By acting as a common denominator it permits everything to be priced, that is, valued in terms of money. Thus, people are enabled to compare different prices and thus see the relative values of different goods and services.

This serves two basic purposes:

- (1) Households (consumers) can plan their expenditure and
- (2) Business people can keep records of income and costs in order to work out their profit and loss figures.

3. A Store of Value (Purchasing Power):

A major disadvantage of using commodities — such as wheat or salt or even animals like horses or cows — as money is that after a time they deteriorate and lose economic value. They are, thus, not at all satisfactory as a means of storing wealth. To realise the problems of saving in a barter economy let us consider a farmer. He wanted to save some wheat each week for future consumption. But this would be of no use to him in his old age because the 'savings' would have gone off.

Again, if a coal miner wanted to set aside a certain amount of coal each week for the same purpose, he would have problems of finding enough storage space for all his coal. By using money, such problems can be overcome and people are able to save for the future. Modern form of money (such as coins, notes and bank deposits) permit people to save their surplus income.

4. The Basis of Credit:

Money facilitates loans. Borrowers can use money to obtain goods and services when they are needed most. A newly married couple, for example, would need a lot of money to completely furnish a house at once. They are not required to wait for, say ten years, so as to be able to save enough money to buy costly items like cars, refrigerators, T.V. sets, etc.

5. A Unit of Account:

An attribute of money is that it is used as a unit of account. The implication is that money is used to measure and record financial transactions as also the value of goods or services produced in a country over time. The money value of goods and services produced in an economy in an accounting year is called gross national product.

6. A Standard of Postponed Payment:

This is an extension of the first function. Here again money is used as a medium of exchange, but this time the payment is spread over a period of time. Thus, when goods are

bought on hire-purchase, they are given to the buyer upon payment of a deposit, and he then pays the remaining amount in a number of installments.

Types of Monetary Standards: Metallic and Paper Standard | Economics

A. Metallic Standard:

Under metallic standard, the monetary unit is determined in terms of some metal like gold, silver, etc. Standard coins are made out of the metal. Standard coins are full-bodied legal tender and their value is equal to their intrinsic metallic worth. The important thing to note is that to be on a metallic standard a country must keep – (a) its monetary unit at a constant value in terms of the selected metal, and (b) its various types of money convertible into the selected metal at constant values.

Metallic standard may be of two types:

1. Monometallism
2. Bimetallism.

1. Monometallism:

Monometallism refers to the monetary system in which the monetary unit is made up or convertible to only one metal. Under monometallic standard, only one metal is used as standard money whose market value is fixed in terms of a given quantity and quality of the metal.

Features of Monometallism:

Essential features of monometallic standard are given below:

- (i) Standard coins are defined in terms of only one metal.
- (ii) These coins are accepted as unlimited legal tender in the discharge of day-to-day obligations.
- (iii) There is free coinage (i.e., manufacture of coins) of the metal.
- (iv) There are no restrictions on the export and import of metal to be used as money.
- (v) Paper money also circulates, but it is convertible into standard metallic coins.

Types of Monometallism:

Monometallism can be of two types:

a. Silver Standard:

Under silver standard, the monetary unit is defined in terms of silver. The standard coins are made of silver and are of a fixed weight and fineness in terms of silver. They are unlimited tender. There is no restriction on the import and export of silver. The silver standard remained in force in many countries for a long period.

India remained on silver standard from 1835 to 1893. During this period, Rupee was the standard coin and its weight was fixed at 180 grains and fineness 11/12. The coinage of the Rupee was free and people can get their silver converted into coins at the mint. Similarly, silver coins could be melted into bullion.

b. Gold Standard:

Gold standard is the most popular form of monometallic standard; the monetary unit is expressed in terms of gold. The standard coins possess a fixed weight and fineness of gold. The gold standard remained widely accepted in most of the countries of the world during the last quarter of the 19th century and the first quarter of the 20th century.

Merits of Monometallism:

Monometallic standard has the following advantages:

i. Simplicity:

Since only one metal is used as a standard of value, monometallism is simple to operate and easy to understand.

ii. Public Confidence:

Since the standard money is made of a precious metal (gold or silver), it inspires public confidence.

iii. Promotes Foreign Trade:

Monometallism facilitates and promotes foreign trade. Gold or silver standard is easily acceptable as an international means of payment.

iv. Avoids Gresham's Law:

Monometallism avoids the operation of Gresham's law. According to this law, when both good as well as bad money exist in the economy, bad money tends to drive out of circulation good money.

v. Self-Operative:

It makes the supply of money self-operative. If there is surplus money supply, the value of money will fall and the people will start converting coins into metal. This will wipe out the surplus money, thus creating a balance.

Demerits of Monometallism:

The following are the demerits of monometallism:

i. Costly Standard:

It is a costly standard and all countries, particularly the poor countries, cannot afford to adopt it.

ii. Lacks Elasticity:

Monometallism lacks elasticity. Money supply depends upon the metallic reserves. Thus, money supply cannot be changed in accordance with the requirements of the economy.

iii. Retards Economic Growth:

Economic growth requires expansion of money supply to meet the increasing needs of the economy. But, under monometallism, scarcity of metal may create scarcity of money supply which, in turn, may hinder economic growth.

iv. Lacks Price Stability:

Since the price of the metal cannot remain perfectly stable, the value of money (or the internal price level) under monometallism lacks stability.

2. Bimetallism:

Bimetallism is a monetary system which attempts to base the currency on two metals. According to Chandler, "A bimetallic or double standard is one in which the monetary unit and all types of a nation's money are kept at constant value in terms of gold and also in terms of silver." Under bimetallism two metallic standards operate simultaneously.

Two types of standard coins from two different metals (say gold and silver) are minted. Both the types of standard coins become unlimited legal tender and a fixed ratio of exchange based on mixed ratio of exchange based on mint parity is prescribed for them. Provisions for unlimited purchase, sale and redeem-ability are extended to both metals.

Features of Bimetallism:

(i) A bimetallic standard is based on two metals; it is the simultaneous maintenance of both gold and silver standards.

(ii) There is free and unlimited coinage of both metals.

(iii) The mint ratio of the values of gold and silver at the mint is fixed by the government.

(iv) Two types of standard coins (i.e., gold coins and silver coins) are in circulation at the same time.

(v) Both the coins are full-bodied coins. In other words, the face value and the intrinsic value of both the coins are equal

(vi) Both the coins are unlimited legal tenders. They are also convertible into each other.

(vii) There is free import and export of both the metals.

Merits of Bimetallism:

The merits of bimetallism are discussed below:

i. Convenient Full-Bodied Currency:

Bimetallism provides convenient full-bodied coins for both large and small transactions. It provides portable gold money for large transactions and convenient silver money for smaller payments. This argument has, however, lost its force now when credit money has developed.

ii. Price Stability:

Under this monetary system, the shortage of one metal can be offset by increasing the output of the other metal. Consequently, stability in the prices of both the metals and hence, in the internal prices can be ensured.

iii. Exchange Rate Stability:

Bimetallism ensures stability of exchange rate. As long as gold and silver are stabilised in terms of each other, the currencies of all countries with fixed values in gold or in silver would exchange for each other at nearly constant rates.

iv. Sufficient Money Supply:

Under bimetallism, sufficient money supply is assured to meet the trade requirements of the economy. Since there is no question of both metals becoming scarce simultaneously, money supply is more elastic under this system.

v. Maintenance of Bank Reserves:

Under bimetallism, the maintenance of bank reserves becomes easy and economical. Under this system, both gold and silver coins are standard coins and unlimited tender. Therefore, it is easy for the banks to keep their cash reserves either in gold coins or in silver coins or in both.

vi. Low Interest Rates:

Since, under bimetallism, money is made of two metals, its supply is generally more than its demand. As a result, the interest rates decline. Banks can extend loans at cheaper rates. This would increase investment and hence production in the economy.

vii. Stimulates Foreign Trade:

Bimetallism stimulates international trade in two ways, – (a) A country on bimetallism can have trade relations with both gold standard and silver standard countries, (b) There are no restrictions on imports and exports due to the free inflow of both types of coins.

Demerits of Bimetallism:

Bimetallism has the following demerits:

i. Operation of Gresham's Law:

Bimetallism in a single country is a temporary and not workable monetary standard due to the operation of Gresham's law.

ii. Inequality between Mint and Market Rates:

Bimetallism can operate successfully only if the equality between the market rate and the mint rate can be maintained. But, in practice, it is difficult to maintain equality between the two rates, particularly when one metal is oversupplied than the other.

iii. No Price Stability:

The argument that bimetallism ensures internal price stability and there will be an automatic adjustment between supply and demand for money is illusionary. There can be a possibility of both the metals to become scarce.

iv. Payment Difficulties:

Bimetallism leads to difficult situation in the settlement of transactions when one party insists on payment in terms of a particular type of coins.

v. Encourages Speculative Activity:

It encourages speculative activity in the two metals when their prices fluctuate in the market.

vi. No Stimulus to Foreign Trade:

International trade is stimulated if all the countries adopt bimetallism. But, this is a rare possibility in the present circumstances.

vii. Costly Monetary Standard:

Bimetallism is a costly monetary standard and all nations, particularly the poor nations, cannot afford to adopt it.

B. Paper Standard:

Paper standard refers to a monetary standard in which inconvertible paper money circulates as unlimited legal tender. Under paper money standard, although the standard money is made of paper, both currency and coins serve as standard money for purpose of payment. No gold reserves are required either to back domestic paper currency or to facilitate foreign payments.

Merits of Paper Standard:

Various merits of paper standard are described below:

1. Economical:

Since under paper standard no gold coins are in circulation and no gold reserves are required to back paper notes, it is the most economical form of monetary standard. Even the poor countries can adopt it without any difficulty.

2. Proper Use of Gold:

Wastage of gold is avoided and this precious metal becomes available for industrial, art and ornamental purpose.

3. Elastic Money Supply:

Since paper money is not linked with any metal, the government or the monetary authority can easily change the money supply to meet the industrial and trade requirements of the economy.

4. Ensures Full Employment and Economic Growth:

Under paper standard, the government of a country is free to determine its monetary policy. It regulates its money in such a way that ensures full employment of the productive resources and promotes economic growth.

5. Avoids Deflation:

Under paper standard, a country avoids deflationary fall in prices and incomes which is the direct consequence of gold export. Such type of situation arises under gold standard when a participating country experiences adverse balance of payments. This results in the outflow of gold and contraction of money supply.

6. Useful during Emergency:

Paper currency is very useful in times of war when large funds are needed to finance war. It is also best suited to the less developed countries like India. To these economies, it makes available large amounts of financial resources through deficit financing for carrying out developmental schemes.

7. Internal Price Stability:

Under this system, the monetary authority of a country can establish stability in the domestic price level by regulating money supply in accordance with the changing requirements of the economy.

8. Regulation of Exchange Rate:

Paper standard provides more effective and automatic regulation of exchange rate, whereas, under gold standard, the exchange rate is absolutely fixed. Whenever, exchange rate fluctuates as a result of disequilibrium between demand and supply forces, the paper standard works on imports and exports and restores equilibrium. It allows the forces of demand and supply to operate freely to establish equilibrium.

Demerits of Paper Standard:

The paper standard suffers from the following defects:

1. Exchange Instability:

Since the currency has no link with any metal under paper currency, there are wide fluctuations in the foreign exchange rates. This adversely affects the country's international trade. Exchanging instability arises whenever external prices move more than domestic prices.

2. Internal Price Instability:

Even the commonly claimed advantage of paper standard, i.e., domestic price stability, may not be achieved in reality. In fact, the countries now on paper standard experience such violent fluctuations in internal prices as they experienced under gold standard before.

3. Dangers of Inflation:

Paper standard has a definite bias towards inflation because there is always a possibility of over- issue of currency. The government under paper standard generally has a tendency to use managed currency to cover up its budget deficit. This results in inflationary rise in prices with all its evil effects.

4. Dangers of Mismanagement:

Paper currency system can serve the country only if it is properly and efficiently managed. Even the minor mistake in the management of paper currency can bring such disastrous result that cannot be conceived of in any other form of monetary standard. If the government issues little more or little less currency than what is required for maintaining price stability, it may lead to cumulative inflation or cumulative deflation.

5. Limited Freedom:

In the present world of economic dependence, it is almost impossible for a particular country to isolate itself and remain unaffected from the international economic fluctuations simply by adopting paper standard.

6. Absence of Automatic Working:

The paper standard does not function automatically. To make it work properly, the government has to interfere from time to time.

Principles of Note Issue:

At present, all the countries of the world have adopted paper standard.

In fact this standard has proved a boon to the modern monetary system. The central bank of a country, which plays an important role in the paper standard, is assigned the job of note issue.

A good note issue system should possess the following qualities:

(a) It should inspire public confidence, and, for this, it must be based on sufficient reserves of gold and silver.

- (b) It should be elastic in the sense that money supply can be increased or decreased in accordance with the needs of the country.
- (c) It should be automatic and secure.

To ensure a good note issue system, two principles of note issue have been advocated:

- (1) Currency principle and
- (2) Banking principle.

1. Currency Principle:

The currency principle is advocated by the 'currency school' comprising Robert Torrens, Lord Overstone, G. W. Norman and William Ward. Currency principle is based on the assumption that a sound system of note issue should command the greatest public confidence. This requires that the note issue should be backed by 100 per cent gold or silver reserves. Or in other words, paper currency should be fully convertible into gold or silver.

Merits:

The currency principle has the following advantages:

- (i) Since, according to this principle, the paper currency is fully convertible into gold and silver, it inspires maximum confidence of the public.
- (ii) There is no danger of note issue of the paper currency leading to the inflationary pressures,
- (iii) It makes the paper currency system automatic and leaves nothing to the will of the monetary authority.

Demerits:

The currency principle has the following drawbacks:

- (i) The currency principle makes the monetary system inelastic because it does not allow the monetary authority to expand the money supply according to the needs of the country.
- (ii) It requires full backing of gold reserves for note issue. Thus, it makes the monetary system expensive and uneconomical.
- (iii) This principle is not practical for all countries because gold and silver are unevenly distributed among countries.

2. Banking Principle:

The banking principle is advocated by the 'banking school', the important members of which are Thomas Tooke, John Fullarton James, Wilson and J.W. Gilbart. The banking principle is based on the assumption that the common man is not much interested in getting his currency notes converted into gold or silver.

Merits:

The following are the merits of banking principle:

- (i) The banking principle renders note issue system elastic. The monetary authority can change the supply of currency according to the needs of the economy.
- (ii) Since the banking principle does not require 100 percent metallic backing against the note issue, it is the most economic principle and thus can be followed by both rich and poor countries.

Demerits:

The banking principle has the following demerits:

- (i) The banking principle is inflationary in nature, because it involves the danger of over-issue of paper currency.
- (ii) The monetary system based on the banking principle does not command public confidence because the system is not fully backed by metallic reserves.

Methods of Note Issue:

Different countries have adopted various methods of note-issue in different periods.

Important methods of note-issue are discussed below:

1. Simple Deposit System:

Under the simple deposit system, the paper currency notes are fully backed by the reserves of gold or silver or both. This system is based on the currency principle of note issue. This method involves no danger of over-issue of currency and commands maximum degree of public confidence. But, this system has never been practised because it is very costly and has no elasticity of money supply.

2. Fixed Fiduciary System:

Under the fixed fiduciary system, the central bank is authorised to issue only a fixed amount of currency notes against government securities. All notes issued in excess of this limit should be fully backed by gold and silver reserves. Fiduciary issue means the issue of currency notes without the backing of gold and silver. This system was first introduced in England under the Bank Charter Act of 1844 and still prevails there. India followed this system between 1862 to 1920.

Merits:

Fixed fiduciary system has the following advantages:

- (i) It ensure convertibility of currency notes.
- (ii) It inspires public confidence since the government guarantees the convertibility of notes.
- (iii) There is no danger of over-issue of paper notes because barring a certain portion, the entire note issue is backed by gold reserves.

Demerits:

The main disadvantages of the fixed fiduciary system are:

- (i) It makes the monetary system less elastic. In times of economic crises, money supply cannot be increased without keeping additional gold in reserve.
- (ii) It is a costly system which requires sufficient gold reserves. Poor countries cannot afford to adopt it.
- (iii) It is inconvenient method because whenever gold reserves fall, the central bank has to reduce the supply of currency which greatly disturbs the functioning of the economy.

3. Proportional Reserves System:

Under the proportional reserve system, certain proportion of currency notes (40%) are backed by gold and silver reserves and the remaining part of the note issue by approved securities. India adopted this method on the recommendation of Wilton Young Commission.

Merits:

The proportional reserve system has the following advantages:

- (i) It guarantees convertibility of paper currency.
- (ii) It ensures elasticity in the monetary system; the monetary authority can issue paper currency much more than that warranted by reserves.
- (iii) It is economical and can be easily adopted by the poor countries.

Demerits:

The proportional reserves system suffers from the following defects:

- (i) Under this system, it is easy to expand currency but very difficult to reduce it. The reduction of currency has deflationary effects in the economy.
- (ii) There is wastage of gold because large amount of gold lies in the reserve and cannot be put to productive use.
- (iii) The convertibility of paper notes is not real. In practice, high denomination notes are converted into low denomination notes and not into coins.

4. Minimum Fiduciary System:

Under the minimum fiduciary system, the minimum reserves of gold against note issue that the authority is required to maintain are fixed by law. Against these minimum reserves, the monetary authority can issue as much paper currency as is considered necessary for the economy. There is no upper limit fixed for the issue of currency.

Merits:

The minimum reserve system has the following advantages:

- (i) The system is economical because the entire note issue need not be backed by metallic reserves. Only a minimum reserve is to be maintained.
- (ii) It renders elasticity to the monetary system. After maintaining the minimum reserves, the monetary authority can issue any amount of currency that it feels necessary.

Demerits:

The minimum reserve system has the following drawbacks:

- (i) Since, under this system, no additional reserves are required for increasing the supply of currency, there is always a tendency towards the over-issue of currency, and hence an inherent danger of inflationary pressures.
- (ii) Since the system provides no convertibility of currency notes into gold, it lacks public confidence.

5. Maximum Reserve System:

Under this system, the government fixes the maximum limit upto which the monetary authority can issue notes without the backing of metallic reserves. The monetary authority cannot issue notes beyond this limit. The maximum limit is not rigid and may be revised from time to time according to the changing needs of the economy.

Ideal Monetary System:

An ideal monetary standard should be able to achieve the twin objectives of – (a) growth and full employment with reasonable price stability within the country, and (b) smooth flow of goods, services and capital at the international level. Such an ideal monetary system requires wise blending of both paper and gold standards. This blending will provide the advantages of both the standards, with none of their disadvantages.

In modern times, the establishment of International Monetary Fund (IMF) and the International Bank of Reconstruction and Development (IBRD) has been designed to give the ideal monetary system a practical shape. These institutions have been able – (a) to make the paper standard function efficiently both internally and internationally by removing its various defects; and (b) to operate international affairs quite successfully, thus promoting trade and cooperation among the nations.

Present Currency System of India:

The monetary system prevailing in India at present is managed and controlled by the Reserve Bank India. The present monetary system is based on inconvertible paper currency, supplemented by coins. On the external front Indian currency 'rupee' is again convertible to various other currencies of the world. Although in narrow sense, the term money supply includes only the assets having ready liquidity but in wider sense, it also includes various other assets.

Accordingly, in India, total money supply includes:

- (a) Rupee coins and small coins.
- (b) Rupee Notes or currency in circulation of different denominations and
- (c) The deposits of commercial banks.

Rupee Coins and Small Coins:

In India, the rupee is the monetary unit of account and it is based on the decimal system. Being a token coin its face value is always higher than its content (intrinsic) value. The rupee is also printed on paper by the Ministry of Finance, Government of India. The rupee and the half-rupee coins are considered of unlimited legal tenders.

Small coins are subsidiary coins, which are consisting of 50 paise, 25 paise and other decimal coins. Small coins bearing the value 25 paise and other coins of small face value are limited legal tender, which the people may refuse to accept in large volume.

Rupee Notes or Currency Notes in Circulation:

The rupee notes or currency notes contain the major portion of the total money supply of the country. The sole authority to print currency note rests with the Reserve Bank of India (RBI) and the notes and coins are guaranteed by the RBI Governors. Due to limitation in its supply, these notes and coins are maintaining its value.

The RBI has the authority to print and issue currency notes of different denominations right from two rupee notes to ten-thousand rupee notes. A separate Issue Department of the RBI looks after the issue of currency. Although the Issue Department previously maintained a proportional system of reserve mode of gold and government securities but this system was abandoned later on.

At present the Issue Department is maintaining minimum reserve system where it maintains a minimum reserve of gold and foreign securities to the extent of Rs. 200 crore of which the gold reserve should be of minimum value not less than Rs. 115 crore. Total value of RBI notes circulated in India has increased from Rs. 1,910 crore in 1960-61 to Rs. 59,860 crore at the end of June 1991.

Again total variations of money stock or broad money (M_3) consisting of currency with the public, demand deposits with banks, time deposits with banks and other deposits to RBI stood at Rs. 1,54,311 crore in 1998-99 (Jan. 16 to Jan. 15).

Total money supply with the public has also increased from Rs. 7,320 crore in 1970-71 to Rs. 1,45,000 crore in 1993-94. The increase in money supply in the country has mostly resulted from the policy of deficit financing pursued by the government and rise in the demand for money for increasing volume of production and trade.

The present currency note is an inconvertible paper note and the same cannot be issued by the RBI in unlimited amount. There is a limit to the power of Issue Department of RBI to issue paper currency. The entire issue of currency note is subjected to the regulations framed in the RBI Act of 1935. Since 1856, various amendments had already been made to the RBI Act. Under the present provisions of RBI Act, the issue of additional doses of currency notes can be made by the RBI without keeping any additional reserves of gold or foreign exchange.

Bank Deposits:

The commercial banks are also creating money through their power to create deposits. Thus, the money supply of the country includes current deposits with banks as they can be withdrawn or transferred easily from one bank to another bank. Commercial banks normally collect deposits from the public and while offering loans they also create credit in multiple amount of primary deposit. Thus through lending operation, there would be secondary expansion of bank deposits. Such secondary expansion of bank deposits is under full control of the RBI.

Total Volume of Money Supply:

In recent years, the volume of money supply in India has been increasing at a steady rate. Money supply with the public (M_1) includes two items, i.e. currency with the public and total

deposits. Again the currency with the public is consisting of currency notes, rupee coins or notes and small coins in circulation minus the amount of balances held at treasuries and commercial banks.

Objectives of Monetary Policy: 6 Objectives | India

1. High employment:

Any modern government is committed to promote high employment.

High employment is a desirable goal of monetary policy for two main reasons:

(1) high unemployment causes much human misery, with families suffering financial distress and loss of personal self- respect,

(2) secondly, when unemployment is high, the economy has not only idle workers but also idle resources (closed factories and unused equipment), resulting in a loss of output (lower GDP). So, society's actual output or GDP will be less than its potential (full employment) output.

At first, it might seem that full employment is the point at which no worker is' out of a job, that is, when unemployment is zero. But, this definition ignores the fact that some unemployment, called fractional unemployment, is beneficial to the economy.

2. Price stability:

Over the past two decades, macroeconomists have become more aware of the social and economic costs of inflation and more concerned with a stable price level as a goal of economic policy. Price stability is desirable in a developing country like India, because a rising price level (inflation) creates considerable uncertainty in the economy.

3. Interest-rate stability:

Interest-rate stability is desirable because fluctuations in interest rates can create uncertainty in the economy and make it more and more difficult to plan for the future. Fluctuations in interest rates also affect consumers' willingness to buy durable goods, such as houses, motor cars, refrigerators, washing machines or even personal computers.

4. Stability of financial markets:

A major reason for the creation of the central bank is that it can promote a more stable financial system. One way in which the central bank promotes stability is helping prevent financial panics (particularly bank failure) through its role as lender of last resort. The central bank is the ultimate source of funds in the money market.

5. Stability in foreign exchange markets:

With the increasing importance of international trade to the Indian economy, the value of the rupee relative to other currencies has become a major consideration for the RBI. A rise in the value of the rupee makes Indian industries less competitive with those abroad, and declines in the value of the rupee stimulate inflation in India.

6. Economic growth:

The goal of steady economic growth is closely related to the high employment goal, because businesses are more likely to invest in capital equipment to increase productivity and economic growth when unemployment is low. Conversely, if unemployment is high and factories are idle, it does not pay for a firm to invest in additional plants and equipment.

Instruments of Monetary Policy

Monetary policy is a way for the RBI to control the supply of money in the economy. So these credit policies help control the inflation and in turn help with the economic growth and

development of the country. So now let us take a look at the various instruments of monetary policy that the RBI has at its disposal.

1] Open Market Operations

Open Market Operations is when the RBI involves itself directly and buys or sells short-term securities in the open market. This is a direct and effective way to increase or decrease the supply of money in the market. It also has a direct effect on the ongoing rate of interest in the market.

Let us say the market is in equilibrium. Then the RBI decides to sell short-term securities in the market. The supply of money in the market will reduce. And subsequently, the demand for credit facilities would increase. And so correspondingly the rate of interest would also see a boost.

2] Bank Rate

One of the most effective instruments of monetary policy is the bank rate. A bank rate is essentially the rate at which the RBI lends money to commercial banks without any security or collateral. It is also the standard rate at which the RBI will buy or discount bills of exchange and other such commercial instruments.

3] Variable Reserve Requirement

There are two components to this instrument of monetary policy, namely – The Cash Reserve Ratio (CLR) and the Statutory Liquidity Ratio (SLR). Let us understand them both.

Cash Reserve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. So CRR is the percent of deposits the commercial banks have to keep with the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank. And accordingly, the loans given by the bank will either become cheaper or more expensive. The CRR is a great tool to control inflation.

4] Liquidity Adjustment Facility

The Liquidity Adjustment Facility (LAF) is an indirect instrument for monetary control. It controls the flow of money through repo rates and reverse repo rates. The repo rate is actually the rate at which commercial banks and other institutes obtain short-term loans from the Central Bank.

5] Moral Suasion

This is an informal method of monetary control. The RBI is the Central Bank of the country and thus enjoys a supervisory position in the banking system. If there is a need it can urge the banks to exercise credit control at times to maintain the balance of funds in the market. This method is actually quite effective since banks tend to follow the policies set by the RBI.

Limitations of the monetary policy

1. Restricted Scope of Monetary Policy in Economic Development:

In reality the monetary policy has been assigned only a minor role in the process of economic development. The monetary policy is not given any predominant role in the process of economic development.

2. Limited Role in Controlling Prices:

The monetary policy of Reserve bank has played only a limited role in controlling the inflationary pressure. It has not succeeded in achieving the objective of growth with stability.

3. Unfavourable Banking Habits:

An important limitation of the monetary policy is unfavourable banking habits of Indian masses. People in India prefer to make use of cash rather than cheque. This means that a major

portion of the cash generally continues to circulate in the economy without returning to the banks in the form of deposits. This reduces the credit creation capacity of the banks.

4. Underdeveloped Money Market:

Another limitation of monetary policy in India is underdeveloped money market. The weak money market limits the coverage, as also the efficient working of the monetary policy.

5. Existence of Black Money:

The existence of black money in the economy limits the working of the monetary policy. The black money is not recorded since the borrowers and lenders keep their transactions secret. Consequently the supply and demand of money also not remain as desired by the monetary policy.

6. Conflicting Objectives:

An important limitation of monetary policy arises from its conflicting objectives. To achieve the objective of economic development the monetary policy is to be expansionary but contrary to it to achieve the objective of price stability a curb on inflation can be realised by contracting the money supply.

7. Influence of Non-Monetary Factors:

An important limitation of monetary policy is its ignorance of non-monetary factors. The monetary policy can never be the primary factor in controlling inflation originating in real factors, deficit financing and foreign exchange resources.

8. Limitations of Monetary Instruments:

An important limitation of monetary policy is related to the inherent limitations in the various instruments of credit control. There are limitations regarding frequent and sharp changes in the bank rate, as these are supposed to conflict with the development objectives. Most bank rates are virtually fixed and mutually unrelated so that the scope for adjustment is very limited.

9. Not Proper Implementation of the Monetary Policy:

Successful application of monetary policy is not merely a question of availability of instruments of credit control. It is also a question of judgement with regard to timing and the degree of restraint employed or relaxation allowed.

Nature of public finance – distinction between public finance and private finance – sources of revenue – public expenditure and public dept – fiscal policy objective, instruments and limitations

Meaning and Definition of Public Finance:

Public finance is a study of income and expenditure or receipt and payment of government. It deals the income raised through revenue and expenditure spend on the activities of the community and the terms ‘finance’ is money resource i.e. coins. But public is collected name for individual within an administrative territory and finance. On the other hand, it refers to income and expenditure. Thus public finance in this manner can be said the science of the income and expenditure of the government. Different economists have defined public finance differently. Some of the definitions are given below.

According to prof. **Dalton** “public finance is one of those subjects that lie on the border lie between economics and politics. It is concerned with income and expenditure of public authorities and with the mutual adjustment of one another. The principal of public finance are the general principles, which may be laid down with regard to these matters.

According to **Adam Smith** “public finance is an investigation into the nature and principles of the state revenue and expenditure”

To sum up, public finance is the subject, which studies the income and expenditure of the government. In simpler manner, public finance embodies the study of collection of revenue and expenditure in the public interest for the welfare of the country

Nature of Public Finance

Nature of Public finance implies whether it is a science or art or both.

1. Public Finance is a Science: Science is a systematic study of any subject which studies casual relationship between facts. Public finance is a systematically study relating to revenue and expenditure of the government. It also studies the casual relationship between facts relating to revenue and expenditure of the government. Prot.

Plehn has advanced the following arguments in favour of public finance being science:

- i.** Public finance is not a complete knowledge about human rather it is concerned with definite and limited field of human knowledge.
- ii.** Public finance is a systematic study of the facts and principles relating to government revenue and expenditure.
- iii.** Scientific methods are used to study public finance.
- iv.** Principles of public finance are empirical.

Science is of two types:

- a)** Positive science and
- b)** Normative science.

In positive science one knows about factual situation or facts as they are. It describes “what is”. As against it, normative science presents norms or ideals. It describes “what ought to

be” or what is right or wrong i.e. value judgement. By the study of public finance one gets factual information about the problems of government’s revenue and expenditure. Public finance is therefore, a positive science. Study of public finance also reveals what should be the quantum of taxes. Which taxes, direct or indirect, should be imposed. On what items more or on what items less of public expenditure be incurred. Public finance is therefore a normative science. Thus, study of public finance offers suggestions regarding revenue and expenditure of the government as also apprises of their factual position.

2. Public Finance is an Art: In the words of J.N. Keynes, ”Art is the application of knowledge for achieving definite objectives.” Fiscal policy which is an important instrument of public finance makes use of the knowledge of the government’s revenue and expenditure to achieve the objectives of full employment, economic equality , economic development and price stability, etc. To achieve the objective of economic equality taxes are levied at progressive rate. Since every tax is likely to be opposed, it becomes essential to plan their timing and volume. The process of levying tax is certainly an art. Budget making is an art in itself. Study of public finance is helpful in solving many practical problems. Public finance is therefore an art also. In sort, public finance is both science and art. It is a positive science as well as normative science.

Differences between Public and Private Finance

1. Income and Expenditure Adjustment in Public and Private Finance

The government adjusts the income according to the expenditure budget. The private sector including individuals and private businesses adjust their expenditure according to the income or future estimates. The government first creates an outline for the expenditure then devices means of acquiring the monetary budget needed. Private finance involves cutting your coat according to your cloth.

2. Borrowing in Public vs. Private Finance

The government can borrow from itself, it can simply go back to the people to ask for loans in whichever financial asset e.g. bonds, when shortages arise. However, an individual can’t borrow from itself.

3. Currency ownership in Public vs. Private Finance

The government is in charge of all aspects related to currency. This involves the creation, distribution and monitoring. No one in the private sector is allowed to create currency, this is illegal and most countries classify it as a capital offense.

4. Present vs. future Income

The public sector is more involved with future planning and making long-term decisions. The government makes decisions that will bear fruits in the long-term even ten years. These investments could include building of schools, hospitals and infrastructure. The private industry makes financial decisions on projects with a shorter returns waiting time.

5. Objective Difference in Public and Private Finance

The public sector’s main objective is to create social benefit in the economy. The private industry seeks to maximize on personal or profit benefits.

6. Coercion to Get Revenue

The government can use force to get revenue from individuals. This could involve the use of force to get taxes. The private sector however, doesn’t have this authority.

7. Ability to Make Huge and Deliberate Changes

The public finance sector has the ability to make huge decisions on income amount without much consequences. For example, it can effectively and deliberately increase or decrease the income amount instantly. Businesses and individuals can't make these decisions and implement them immediately.

8. Surplus Budget Concept

Excess income or surplus budgets is a great virtue in the private sector, this is however not the case in public finance. The government is expected to only raise what is needed for a fiscal year. Of what use would it be to have surplus budgets? It would be much easier to offer tax reliefs to the tax-payers so as to off-set the surplus.

Sources of Government Revenue in India

The following points highlight the two main sources of government revenue in India.

A. Tax Revenue:

Union Excise Duties:

They are, presently, by far the leading source of revenue for the Central Government and are levied on commodities produced within the country, but excluding those commodities on which State excise is levied (viz., liquors and narcotic drugs).

The most important commodities from the revenue point of view are sugar, cotton, mill cloth, tobacco, motor spirit, matches and cement.

Customs:

Customs duties include both import and export duties. These are the second-most important source of revenue for the Central Government.

Income Tax:

Income tax is at present another important source of revenue for the Central Government. It is levied on the incomes of individuals, Hindu undivided families and unregistered firms.

Corporation Tax:

The income-tax on the net profits of joint stock companies is called corporation tax.

Wealth Tax:

It is an annual tax on the net wealth of individuals and Hindu undivided families. It is a progressive tax.

Gift Tax:

It is a tax on gifts of property by an individual in his lifetime to future successors.

Capital Gains Tax:

It is applicable to capital gains resulting from the sale, exchange or transfer of capital assets.

Hotel Expenditure Tax:

Recently, a new tax has been levied on those who patronise high class hotels.

Tax on Foreign Travel:

Another new tax levied on foreign travel for conserving foreign exchange as well as to raise revenue.

B. Non-Tax Revenue:

Interest Receipts:

This largest non-tax source of Central Government's revenue receipts is the interest it earns mainly on the loans it has advanced to State Governments, to financial and industrial enterprises in the public sector.

Surplus Profits of the Reserve Bank of India (RBI):

The surplus profits of the RBI is also a part of the revenues of the Central Government. In recent years, these have been quite substantial because of the large borrowing by the Government from the RBI against Treasury Bills for financing the Five-Year Plans.

Currency, Coinage and Mint:

The Government also derives income from running the Currency Note Printing Presses. Moreover, profits are made from the circulation of coins — this profit being the difference between the face value of the coins and their manufacturing cost.

Railways:

The railways in India are owned and run by the Government of India. Accordingly, they pay a fixed dividend to general revenues, i.e., to the Central Government, on the capital invested in the railways. Besides, a part of the net profits made by the railways is also payable to the Central Government.

Profits of Public Enterprises:

Public enterprises owned by the Central Government, e.g., the Steel Authority of India (SAIL), Hindustan Machine Tools (HMT), Bharat Heavy Electricals Ltd. (BHEL), State Trading Corporation (STC). The profits of such Public Sector Units (PSUs) are another source of revenue for the Government of India.

Other Non-Tax Sources of Revenue:

The main source among them is the Departmental Receipts of the various ministries of the Central Government by way of fees, penalties, etc.

Public Expenditure: Causes

Meaning of Public Expenditure:

Expenses incurred by the public authorities—central, state and local self- governments—are called public expenditure. Such expenditures are made for the maintenance of the governments as well as for the benefit of the society as whole.

There was a misbelief in the academic circles in the nineteenth century that public expenditures were wasteful. Public expenditures must be kept low as far as practicable. This conservative thinking died down in the twentieth century, especially after the Second World War.

(a) Size of the Country and Population:

We see an expansion of geographical area of almost all countries. Even in no-man's land one finds the activities of the modern government. Assuming a fixed size of a country, developing world has seen an enormous increase in population growth. Consequently, the expansion in administrative activities of the government (like defence, police, and judiciary) has resulted in a growth of public expenditures in these areas.

(b) Defence Expenditure:

The tremendous growth of public expenditure can be attributed to threats of war. No great war has been conducted in the second half of the twentieth century. But the threats of war have not vanished; rather it looms large. Thus, mere sovereignty, demands a larger allocation of financial sources for defence preparedness.

(c) Welfare State:

The 19th century state was a 'police state' while, in 20th and 21st centuries modern state is a 'welfare state'. Even in a capitalist framework, socialistic principles are not altogether discarded. Since socialistic principles are respected here, modern governments have come out openly for socio-economic uplift of the masses.

(d) Economic Development:

Modern government has a great role to play in shaping an economy. Private capitalists are utterly incapable of financing economic development of a country. This incapacity of the private sector has prompted modern governments to invest in various sectors so that economic development occurs.

(e) Price Rise:

Increase in government expenditure is often ascribed to inflationary price rise.

Public Debt: Meaning, Objectives

Meaning:

In India, public debt refers to a part of the total borrowings by the Union Government which includes such items as market loans, special bearer bonds, treasury bills and special loans and securities issued by the Reserve Bank. It also includes the outstanding external debt.

However, it does not include the following items of borrowings:

- (i) small savings,
- (ii) provident funds,
- (iii) other accounts, reserve funds and deposits.

The aggregate borrowings by the Union Government—comprising the public debt and these other borrowings — are generally known as ‘net liabilities of the Government’.

Objectives:

In India, most government debt is held in long-term interest bearing securities such as national savings certificates, rural development bonds, capital development bonds, etc. In industrially advanced countries like the U.S.A., the term government or public debt refers to the accumulated amount of what government has borrowed to finance past deficits.

The State generally borrows from the people to meet three kinds of expenditure:

- (a) to meet budget deficit,
- (b) to meet the expenses of war and other extraordinary situations and
- (c) to finance development activity.

(a) Public Debt to Meet Budget Deficit:

It is not always proper to effect a change in the tax system whenever the public expenditure exceeds the public revenue. It is to be seen whether the transaction is casual or regular. If the budget deficit is casual, then it is proper to raise loans to meet the deficit. But if the deficit happens to be a regular feature every year, then the proper course for the State would be to raise further revenue by taxation or reduce its expenditure.

(b) Public Debt to Meet Emergencies like War:

In many countries, the existing public debt is, to a great extent, on account of war expenses. Especially after World War II, this type of public debt had considerably increased. A large portion of public debt in India has been incurred to defray the expenses of the last war.

(c) Public Debt for Development Purposes:

During British rule in India public debt had to be raised to construct railways, irrigation projects and other works. In the post-independence era, the government borrows from the public to meet the costs of development work under the Five Year Plans and other projects. As a result the volume of public debt is increasing day by day.

It creates three problems:

- (1) Distorting effects on incentives due to extra tax burden,

- (2) Diversion of society's limited capital from the productive private sector to unproductive capital sector, and
- (3) Showing the rate of growth of the economy.

Fiscal Policy – Objectives, Instruments & Limitations

Fiscal policy – Introduction

In modern times, the policies of the government of a country have very much influence on economic activities. Fiscal policy is the policy related to revenue, expenditure, and debt of the government for achieving a set of definite objectives.

Term '**Fisc**' in the English language means '**Treasury**'. Hence policy relating to the treasury is called fiscal policy.

Objectives of Fiscal Policy

a) Full Employment

Every government aims at maintaining full employment situation in the country. To achieve this objective and to increase aggregate demand the government increases public expenditure and reduces tax. Increase in aggregate demand will lead to more production and employment.

b) Price stability

Another important objective of fiscal policy is to achieve price stability. In the case of rising prices or inflation, the fiscal policy seeks to reduce aggregate demand by reducing public expenditure and increasing direct and indirect taxes.

In the event of falling prices or deflation, the fiscal policy seeks to increase aggregate demand by increasing public expenditure and lowering the rate of taxation.

c) Reduction in Economic Inequality

In a democratic country economic equality is also to be removed through appropriate fiscal measures.

To achieve this objective, progressive direct taxes – like Income tax, wealth tax, are levied.

The incidence of these taxes is more on the rich. The taxes collected are spent in providing more and more facilities to the weaker sections of the society. As such, the standard of living of the poor begins to improve.

d) Economic Development

The fiscal policy seeks to increase the rate of capital formation. In an underdeveloped economy, an increase in the rate of capital formation is the sole determining factor to increase output and employment and hence, economic employment and development.

Instruments of Fiscal Policy

a) Taxation policy-

The government collects large funds from the public by way of taxes. Aggregate can be influenced by taxes. There are various kinds of taxes broadly classified as **direct and indirect tax**.

As a result, of taxes either the monetary income of the people is diminished or prices of goods increase.

In other words, the real income of the people is diminished and so, also their aggregate demand.

Effect of taxes on aggregate demand depends on **taxation multiplier**

$$K_t = \Delta Y / \Delta T = - B / 1 - b$$

Here, K_t = Taxation Multiplier

ΔY = Change in Income

ΔT = Change in Taxation

B = Marginal Propensity to Consume

Value of taxation is negative. It means that change in taxation has an Inverse effect on national income.

Fall in taxation leads to increase national income.

Rise in taxation leads to decrease in national income.

b) Government Expenditure policy-

Aggregate demand is influenced by government expenditure also. On account of the increase in public (government) expenditure, there is an increase in aggregate demand and vice versa.

— **Public expenditure can be of two types-**

i) Public expenditure incurred to buy goods and services. It has a direct effect on aggregate demand.

ii) Public expenditure can also be incurred without buying goods and services, e.g. Expenditure made on pensions, scholarship, education, medical facilities, etc., by the government. Such expenditure is called **Transfer payment**.

Transfer payments have an indirect effect on aggregate demand. Aggregate demand increase when there is an increase in transfer payments.

c) Deficit Financing-

It refers to the financing of the deficit of the government budget. When the government meets its budgetary deficit by borrowing from the central bank it is called '**Deficit financing**'.

Fiscal Policy and Stabilization –

Economic stability refers to the minimum possible changes in the internal price level and foreign exchange rate. Fiscal policy can help to achieve economic stabilization in the following ways –

1) Fiscal Policy and Inflation-

a) Decrease in Public Expenditure

One of the main cause of inflation is the increase in government expenditure. It is, therefore, necessary to curb inflation government should reduce its unnecessary expenditure.

b) Increase in taxes

To check inflation, the government should levy new taxes and raise the rate of old ones.

c) Delay in the Payment of Old Debts

Another way of checking inflation is to defer the repayment of old debts. It will restrict the current flow of money in the economy.

d) Surplus Budget Policy

It implies that the expenditure of the government should be less than its revenue. It will help check inflation.

People will have less purchasing power when the revenue of the government is more than its expenditure.

2) Fiscal Policy and Deflation

a) Increase in Government Expenditure

Under the deflationary situation government (**public**) expenditure must increase. As a result of it, demand will increase. Increase in demand will check the tendency of the prices to fall.

b) Decrease in Taxes

During the depression, taxes should be decreased. As a result of a decrease in direct taxes like- Income Tax, Corporation tax, investors and rich section of the society will promote to invest more.

c) Price Support Policy

During the depression, prices fall heavily. Government, therefore, has to pursue **price support policy**.

d) Pump Priming

During depression, private investment is at its lowest peak. To increase it, public investment becomes very essential. Increase in public investment serves as an incentive to private investment. Such a policy is called **pump priming**.

Limitations of Fiscal Policy-

a) Limited scope

Fiscal policy has its effects only on limited sectors. Most of the sectors in the economy remain unaffected by it.

b) Delay of Decision

In democratic countries, the decision regarding fiscal measures must have the prior approval of the Legislative Assemblies of the Parliament. It is a long and time-consuming process.

c) Non Monetized Sector

A part of the economy is non-monetized. These sectors of the economy remain unaffected by the fiscal policy.

d) Lack of elasticity

The taxation system of underdeveloped countries is not modern, rational and elastic. It is difficult to earn adequate revenue by way of taxes in these economies.

e) Problems of Deficit Financing

Most of the governments, in underdeveloped countries, resort to large scale deficit financing as a fiscal measure for economic development.

Deficit financing, beyond a particular limit, becomes a potent source of inflation. It has an adverse effect on economic development.

f) Illiteracy

Because of rampant illiteracy in underdeveloped countries, most of the people fail to appreciate the significance of fiscal policy. They try their best to avoid taxes.

UNIT V

Features of Indian economy – India's national income – concept, importance and limitation – contribution of different sectors to national income – population and economic development, unemployment problem and its measures to solve – agricultural development causes for low productivity – slow growth of industries in India - causes and remedies composition and direction of foreign trade in India role of economic planning - its achievement and failure in India

Features of the Indian Economy are as follows:

National Income

Usually, income level is used in the determination of the overall well-being and happiness of a country and its citizens.

Therefore, it is one of the important basic characteristics of the Indian Economy. Income of an economy is generally measured through the Gross Domestic Product or GDP.

Here is a quick look at the share of GDP according to the industry of origin:

This change in the composition of national income by industrial origin is the consequence of the process of economic growth. The table below indicates the Compound Annual Growth Rate (CAGR) of various economic activities:

Sectoral Employment in India

So, did the shift in GDP share have any impact on the employment pattern in India?

Here is some data collated from various rounds of the National Sample Surveys:

Capital Formation

Capital formation plays a crucial role in the economic development of a country. Usually, insufficient capital is the primary culprit in underdeveloped or developing economies.

Therefore, both production and consumption are dependent on the amount of capital available in the country.

Capital Formation includes physical resources like tools, machines, etc. as well as human resources like the knowledge, skill, health, etc. of the workforce.

The most important process of accumulating physical capital is increasing the volume of real domestic savings. According to the World Bank, in 2015, the household sector was the biggest contributor to Gross Domestic Savings in India.

Inflation

Managing inflation is the toughest tasks of an economic policy-maker. Inflation is the sustained rise in the general level of prices. There are many factors which influence the rate of inflation in an economy.

In India, fluctuations in prices are a common occurrence due to several natural and economic factors. These fluctuations create an atmosphere of uncertainty which goes against the spirit of the economic development of the country.

Two price indices help in the measurement of Inflation – the Wholesale Price Index (WPI) and the Consumer Price Index (CPI).

Foreign Capital/Investment

In countries like India, the domestic capital is not sufficient for economic growth. Therefore, foreign capital is a way of filling the gap between domestic savings, foreign exchange, government revenue and the investment necessary to achieve the developmental targets.

Apart from being capital-poor, India is also backward in technology required for rapid economic development for many reasons. Foreign capital can provide the required resources to solve the technological backwardness of the country.

Foreign Trade

Traditionally, India was famous for textile and handicrafts exports. During the British era, India became an exporter of raw materials and the British machine-made goods.

However, in the post-independence period, India went through a huge change in its foreign trade policy. Since the introduction of the five-year plans, India started depending heavily on imported machinery and equipment to develop different types of industries.

That was a time when India needed to import capital goods to set up industries. These were developmental imports. Subsequently, India needed to import huge quantities of intermediate goods and raw material to utilize the productive capacity created in the earlier stage. These were maintenance imports.

Definitions of National Income:

According to Marshall: “The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial including services of all kinds. This is the true net annual income or revenue of the country or national dividend.” In this definition, the word ‘net’ refers to deductions from the gross national income in respect of depreciation and wearing out of machines. And to this, must be added income from abroad.

Concepts of National Income

(A) Gross Domestic Product (GDP):

GDP is the total value of goods and services produced within the country during a year. This is calculated at market prices and is known as GDP at market prices. Dernberg defines GDP at market price as “the market value of the output of final goods and services produced in the domestic territory of a country during an accounting year.”

There are three different ways to measure GDP:

Product Method, Income Method and Expenditure Method.

These three methods of calculating GDP yield the same result because National Product = National Income = National Expenditure.

1. The Product Method:

In this method, the value of all goods and services produced in different industries during the year is added up. This is also known as the value added method to GDP or GDP at factor cost by industry of origin. The following items are included in India in this: agriculture and allied services; mining; manufacturing, construction, electricity, gas and water supply; transport, communication and trade; banking and insurance, real estates and ownership of dwellings and business services; and public administration and defense and other services (or government services). In other words, it is the sum of gross value added.

2. The Income Method:

The people of a country who produce GDP during a year receive incomes from their work. Thus GDP by income method is the sum of all factor incomes: Wages and Salaries (compensation of employees) + Rent + Interest + Profit.

3. Expenditure Method:

This method focuses on goods and services produced within the country during one year.

GDP by expenditure method includes:

- (1) Consumer expenditure on services and durable and non-durable goods (C),
- (2) Investment in fixed capital such as residential and non-residential building, machinery, and inventories (I),
- (3) Government expenditure on final goods and services (G),
- (4) Export of goods and services produced by the people of country (X),

(5) Less imports (M). That part of consumption, investment and government expenditure which is spent on imports is subtracted from GDP. Similarly, any imported component, such as raw materials, which is used in the manufacture of export goods, is also excluded.

Thus GDP by expenditure method at market prices = $C + I + G + (X - M)$, where $(X - M)$ is net export which can be positive or negative.

(B) GDP at Factor Cost:

GDP at factor cost is the sum of net value added by all producers within the country. Since the net value added gets distributed as income to the owners of factors of production, GDP is the sum of domestic factor incomes and fixed capital consumption (or depreciation).

Thus GDP at Factor Cost = Net value added + Depreciation.

GDP at factor cost includes:

(i) Compensation of employees i.e., wages, salaries, etc.

(ii) Operating surplus which is the business profit of both incorporated and unincorporated firms. [Operating Surplus = Gross Value Added at Factor Cost—Compensation of Employees—Depreciation]

(iii) Mixed Income of Self-employed.

Conceptually, GDP at factor cost and GDP at market price must be identical/This is because the factor cost (payments to factors) of producing goods must equal the final value of goods and services at market prices. However, the market value of goods and services is different from the earnings of the factors of production.

In GDP at market price are included indirect taxes and are excluded subsidies by the government. Therefore, in order to arrive at GDP at factor cost, indirect taxes are subtracted and subsidies are added to GDP at market price.

Thus, GDP at Factor Cost = GDP at Market Price – Indirect Taxes + Subsidies.

(C) Net Domestic Product (NDP):

NDP is the value of net output of the economy during the year. Some of the country's capital equipment wears out or becomes obsolete each year during the production process. The value of this capital consumption is some percentage of gross investment which is deducted from GDP. Thus Net Domestic Product = GDP at Factor Cost – Depreciation.

(D) Nominal and Real GDP:

When GDP is measured on the basis of current price, it is called GDP at current prices or nominal GDP. On the other hand, when GDP is calculated on the basis of fixed prices in some year, it is called GDP at constant prices or real GDP.

GDP is the value of goods and services produced in a year and measured in terms of rupees (money) at current (market) prices. In comparing one year with another, we are faced with the problem that the rupee is not a stable measure of purchasing power. GDP may rise a great deal in a year, not because the economy has been growing rapidly but because of rise in prices (or inflation).

On the contrary, GDP may increase as a result of fall in prices in a year but actually it may be less as compared to the last year. In both 5 cases, GDP does not show the real state of the economy. To rectify the underestimation and overestimation of GDP, we need a measure that adjusts for rising and falling prices.

This can be done by measuring GDP at constant prices which is called real GDP. To find out the real GDP, a base year is chosen when the general price level is normal, i.e., it is neither too high nor too low. The prices are set to 100 (or 1) in the base year.

Now the general price level of the year for which real GDP is to be calculated is related to the base year on the basis of the following formula which is called the deflator index:

$$\text{Real GDP} = \frac{\text{GDP for the Current Year}}{\text{Current Year Index}} \times \frac{\text{Base Year (=100)}}{\text{Current Year Index}}$$

Suppose 1990-91 is the base year and GDP for 1999-2000 is Rs. 6, 00,000 crores and the price index for this year is 300.

Thus, Real GDP for 1999-2000 = Rs. 6, 00,000 x 100/300 = Rs. 2, 00,000 crores

(E) GDP Deflator:

GDP deflator is an index of price changes of goods and services included in GDP. It is a price index which is calculated by dividing the nominal GDP in a given year by the real GDP for the same year and multiplying it by 100. Thus,

$$\text{GDP Deflator} = \frac{\text{Nominal (or Current Prices) GDP}}{\text{Real (or Constant Prices) GDP}} \times 100$$

$$\text{For example, GDP Deflator in 1997-98} = \frac{1426.7\text{th. crores}}{1049.2\text{th. crores at }=135.9} \times 100$$

It shows that at constant prices (1993-94), GDP in 1997-98 increased by 135.9% due to inflation (or rise in prices) from Rs. 1049.2 thousand crores in 1993-94 to Rs. 1426.7 thousand crores in 1997-98.

(F) Gross National Product (GNP):

GNP is the total measure of the flow of goods and services at market value resulting from current production during a year in a country, including net income from abroad.

GNP includes four types of final goods and services:

- (1) Consumers' goods and services to satisfy the immediate wants of the people;
- (2) Gross private domestic investment in capital goods consisting of fixed capital formation, residential construction and inventories of finished and unfinished goods;
- (3) Goods and services produced by the government; and
- (4) Net exports of goods and services, i.e., the difference between value of exports and imports of goods and services, known as net income from abroad.

Importance of National Income

1. Economic Policy:

National income figures are an important tool of macroeconomic analysis and policy. National income estimates are the most comprehensive measures of aggregate economic activity in an economy. It is through such estimates that we know the aggregate yield of the economy and can lay down future economic policy for development.

2. Economic Planning:

National income statistics are the most important tools for long-term and short-term economic planning. A country cannot possibly frame a plan without having a prior knowledge of the trends in national income. The Planning Commission in India also kept in view the national income estimates before formulating the five-year plans.

3. Economy's Structure:

National income statistics enable us to have clear idea about the structure of the economy. It enables us to know the relative importance of the various sectors of the economy and their contribution towards national income. From these studies we learn how income is produced, how it is distributed, how much is spent, saved or taxed.

4. Inflationary and Deflationary Gaps:

National income and national product figures enable us to have an idea of the inflationary and deflationary gaps. For accurate and timely anti- inflationary and deflationary policies, we need regular estimates of national income.

5. Budgetary Policies:

Modern governments try to prepare their budgets within the framework of national income data and try to formulate anti-cyclical policies according to the facts revealed by the national income estimates. Even the taxation and borrowing policies are so framed as to avoid fluctuations in national income.

6. National Expenditure:

National income studies show how national expenditure is divided between consumption expenditure and investment expenditure. It enables us to provide for reasonable depreciation to maintain the capital stock of a community. Too liberal allowance of depreciation may prove harmful as it may unnecessarily lead to a reduction in consumption.

7. Distribution of Grants-in-aid:

National income estimates help a fair distribution of grants-in-aid by the federal governments to the state governments and other constituent units.

8. Standard of Living Comparison:

National income studies help us to compare the standards of living of people in different countries and of people living in the same country at different times.

9. International Sphere:

National income studies are important even in the international sphere as these estimates not only help us to fix the burden of international payments equitably amongst different nations but also enable us to determine the subscriptions and quotas of different countries to international organisations like the UNO, IMF, IBRD. etc.

10. Defence and Development:

National income estimates help us to divide the national product between defence and development purposes. From such figures we can easily know how much can be spared for war by the civilian population.

11. Public Sector:

National income figures enable us to know the relative roles of public and private sectors in the economy. If most of the activities are performed by the state, we can easily conclude that public sector is playing a dominant role.

Limitations of national income in India.

(i) Non-Monetized Output and Its Transactions:

In the estimation of national income or output, only those goods and services which are exchanged against money are normally included. But in an under-developed country like India, a huge portion of our total output is still either being consumed at home or being bartered away by the producers in exchange of other goods and services leading to the non-inclusion of huge non-monetized output in the national income estimates of the country.

(ii) Non-Availability of Information about Petty Income:

The national incomes estimate in India is also facing another problem of non-availability of information about the income of small producers and household enterprises. In India a very large number of producers are still carrying on production at a family level or are running household enterprises on a very small scale.

(iii) Lack of Differentiation in Economic Functions:

In India the occupational classification is incomplete and thus there is lack of differentiation in economic functions. As National Income Statistics are collected by industrial origin thus classification of producers and workers into various occupational categories is very much essential.

(iv) Unreported Illegal Income:

In India the parallel economy is fully operational as hidden or subterranean economy. Thus there is huge unreported illegal income earned by those people engaged into those parallel economy which is not included in the national income estimates of our country.

(v) Lack of Reliable Statistical Data:

The most important difficulty facing the national income estimation in India is the non-availability of reliable statistical information. In India national income data are collected by untrained and semiliterate persons like gram sevaks and thus the statistics are mostly unreliable.

Contribution of different sectors to national income

1. Agriculture & Allied Sector: This sector includes forestry and fishing also. This sector is also known as the primary sector of the economy. At the time of Indian independence this sector had biggest share in the Gross Domestic Product of India. But year by year its contribution goes on declining and currently it contributes only 17% of Indian GDP at current prices. It is worth to mention that agriculture sector provides jobs to around 53% population of India.

2. Industry Sector: This sector includes 'Mining & quarrying', Manufacturing (Registered & Unregistered), Gas, Electricity, Construction and Water supply. This is also known as the secondary sectors of the economy. Currently it is contributing around 31% of the Indian GDP (at current prices).

3. Services Sector: Services sector includes 'Financial, real estate & professional services, Public Administration, defence and other services, trade, hotels, transport, communication and services related to broadcasting. This sector is also known as tertiary sector of the economy. Currently this sector is the backbone of the Indian economy and contributing around 53% of the Indian GDP.

Population and Economic Development of India!

Population and development are correlated. It is stated that the size of population, rate of growth and population composition, and its geographical distribution are important factors in determining the requirements of infrastructure, such as education, housing, health services, food supply, etc. Productive health capacity is also determined by the size and growth rate of population.

Thus, to make development plans for the present as well as for the future, there is a need to understand the structure and growth of population. A comparison of the developing countries and the more developed countries shows that the birth rate has been high in both categories, but the difference is still quite significant. Table 1 shows the facts in this context.

The developing countries are faced with several contradictions 'n regard to population growth and economic and social development. For example, the birth rate has largely been static from 1900 to 1970, and the death rate has declined considerably because of the development in scientific and economic fields.

Thus, the increase in the population has been phenomenal – almost three times – from 1900 to 1970. The increase in the population of the developed countries has been just nominal.

The birth rate has also declined to the extent of nearly 20 per cent. This clearly shows that along with scientific, technological and educational factors, population is a very important variable in economic development.

Table 1
Birth Rates, Death Rates and the Rates of Natural Increase for the Developing and the More Developed Regions of the World, 1900-1970
(rates per 1,000 population)

| Period | Developing Regions | | | More Developed Regions | | |
|---------|--------------------|------------|--------------------------|------------------------|------------|--------------------------|
| | Birth rate | Death rate | Rate of natural increase | Birth rate | Death rate | Rate of natural increase |
| 1900-50 | 41 | 32 | 9 | 19 | 10 | 9 |
| 1950-60 | 43 | 22 | 21 | 22 | 10 | 12 |
| 1960-70 | 41 | 17 | 24 | 20 | 9 | 11 |

Since 1970 we notice a phenomenal change in birth and death rates and rate of natural increase in both developing and more developed countries. In 2002, in the developing countries, birth rate had declined to 24 from 41, and death rate to 8 from 17 per thousand.

Natural increase also declined from 24 to 16. The birth rate was also on decline in developing countries as from 20 it slide down to 11. Death rate was nearly stable as it was 9 in 1970 and 10 in 2002. However, natural increase declined to 1 from 10. Thus, the pressure of population is still a vital factor in the developing countries.

Solve Unemployment Problem

(i) Change in industrial technique:

Production technique should suit the needs and means of the country. It is essential that labour intensive technology should be encouraged in place of capital intensive technology.

ADVERTISEMENTS:

(ii) Policy regarding seasonal unemployment:

Seasonal unemployment is found in agriculture sector and agro based industries.

To remove it:

- (a) Agriculture should have multiple cropping,
- (b) Plantations, horticulture, dairying and animal husbandry should be encouraged,
- (c) Cottage industries should be encouraged.

(iii) Change in education system:

Educational pattern should be completely changed. Students who have liking for higher studies should be admitted in colleges and universities. Emphasis should be given on vocational education. Qualified engineers should start their own small units.

(iv) Expansion of Employment exchanges:

More employment exchanges should be opened. Information regarding employment opportunities should be given to people.

(v) More assistance to self employed people:

Most people in India are self employed. They are engaged in agriculture, trade, cottage and small scale industries etc. These persons should be helped financially, providing raw materials and technical training.

(vi) Full and more productive employment:

The main objective of county's employment policy should be to increase employment opportunities and productivity of labour. Govt. should adopt a policy that provides employment to all people.

(vii) Increase in Production:

To increase employment, it is essential to increase production in agriculture and industrial sectors. Development of small and cottage industries should be encouraged.

(viii) More importance to employment programmes:

In five year plans more importance should be given to employment. The programmes like irrigation, roads, flood control, power, agriculture, rural electrification can provide better employment to people.

(ix) High rate of capital formation:

Rate of capital formation in the country should be accelerated. Capital formation should be particularly encouraged in such activities which generate greater employment opportunities. Capital output ratio should be kept low.

(x) Industries in co-operative sector:

Industries in co-operative sector should be encouraged. Kerala Govt.' set up a textile mill covering 600 unemployed persons on co-operative basis. This is a novel approach to fight against unemployment. Different State Govt. should take necessary steps in this direction.

(xi) Decentralisation of industrial activity:

Decentralisation of Industrial activity is necessary to reduce unemployment. If industrial activities are centralised at one place, there will be less employment opportunities in the under developed areas. So Govt. should adopt such policies which encourage decentralisation of industrial activity.

(xii) Population control:

The growth of population should be checked in order to solve unemployment, problem. Family planning programme should be implemented widely and effectively.

Causes of the Low Productivity of Agriculture in India

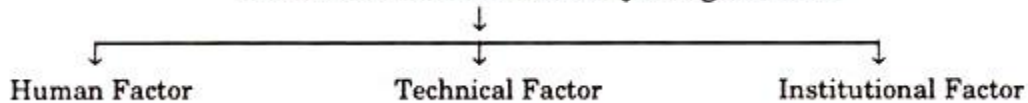
The main causes for low productivity of agriculture are broadly of three types;

1. Human Factors:

Human favors are those which are related to training and efficiency of the farmers.

(i) Social atmosphere:

Causes for Low Productivity of Agriculture



Social climate includes customs and traditions. Indian farmer is illiterate and has no knowledge for latest techniques of production. He believes in God and fatalist in thought. He wastes money on customs and traditions. So social climate is not suitable for agriculture.

(ii) Pressure of population on land:

Heavy pressure of population is the main cause of low productivity of Indian agriculture. In 1901, 16.30 crore people were dependent on agriculture. The number has gone up to 58.80 crore. So per capita cultivable land had reduced from 0.43 hectare to 0.23 hectare. Heavy pressure has led to subdivision and fragmentation of land holdings.

2. Technical Factors:

Technical Factors include techniques and methods of production:

(i) Traditional methods of Cultivation:

Traditional methods of cultivation like manual ploughing, two crop pattern and old system of irrigation are mainly responsible for low productivity of agriculture.

(ii) Old implements:

Traditional equipment's like wooden ploughs, sickles and spades are commonly used. Tractors & Combines are not so common in use. Due to the use of these old implements agriculture is backward.

(iii) Insufficient irrigation facilities:

Indian agriculture is mainly dependent on rain. Even after 60 years of Independence only 40% of the agricultural land has permanent irrigation facility. Due to improper irrigation facility, farmer can produce one crop only in a year.

(iv) Problems of soil:

Indian soil has many problems like soil erosion, water logging, nitrogen deficiency and swamps. These are the reasons for low productivity of agriculture.

(v) Problems of pests and diseases of crops:

Plant diseases like rust and smut and rats, insects and pests destroy large portion of crops.

(vi) Feeble cattle:

Due to limited mechanisation of Indian agriculture, cattle has significant place in agriculture. Cattle are generally weak. Farmer has to spent a lot on these Cattle farming is more time consuming and expensive than tractor. So these also increase the cost of agriculture.

(vii) Lack of credit facility:

Credit facilities are inadequate in rural areas. Farmers can not be able to raise credit from rural banks easily. They have to depend on 'Mahajans' and 'Shahukars'. These money lenders charge heavy rate of interest. Farmers have to sell their produce at low price to these money lenders. So farmers have low Income and thus low productivity.

(viii) Lack of High Yielding Variety (HYV) seeds:

HYV seeds are not commonly used. Farmers do not understand their significance. They cannot afford to buy them and also these seeds are not easily available.

(ix) Improper marketing:

Improper marketing is a significant factor for low productivity of agriculture. Farmers fail to get suitable price for their produce. Inadequate means of transport forces the farmers to sell their produce to local money lenders at low prices. Due to lack of warehousing facilities, farmers can not able to store their produce when prices are low. So these attribute a lot for low productivity of agriculture.

3. Institutional Factors:

Institutional factors include land holdings and land system.

(i) Small size of farms:

Land holdings in India are of very small size. Average size of holding is 2.3 hectare and 70% of the holdings are even less than 2 hectares. These holdings are fragmented. Due to these small holdings, mechanised cultivation is difficult. Implements and irrigation facilities are not properly utilized. It affects Indian agriculture .

(ii) Defective land tenure system:

Zamindari system has been an important factor responsible for the low productivity of Indian agriculture. In this system cultivator is not owner of land. Zamindar is the owner of land and he can evict the tenant any time. So the cultivator does not take interest in the development of land and Zamindar does not take interest in the development of cultivation. Though Zamindari system was abolished after independence yet the position of cultivator has not improved.

Slow growth of industries in India

1. Poor Capital Formation:

Poor rate of capital formation is considered as one of the major constraint which has been responsible for slow rate of industrial growth in India.

2. Political Factors:

During the pre-independence period, industrial policy followed by the British rulers was not at all favourable for the interest of the country. Thus, India remained a primary producing country during 200 years of British rule which ultimately retarded the industrial development of the country in its early period.

3. Lack of Infrastructural Facilities:

India is still backward in respect of its infrastructural facilities and it is an important impediment towards the industrialization of the country. Thus in the absence of proper transportation (rail and road) and communication facilities in many parts of the country, industrial development could not be attained in those regions in spite of having huge development potentialities in those areas.

4. Poor Performance of the Agricultural Sector:

Industrial development in India is very dependent on the performance of the agricultural sector. Thus, the poor performance of the agricultural sector resulting from natural factors is also another important factor responsible for industrial stagnation in the country.

Agriculture provides not only raw materials and foodstuffs but also generates demand for the goods produced by the industrial sector. Thus, this poor performance of the agriculture retards the development of industries in India.

5. Gaps between Targets and Achievements:

In the entire period of planning excepting 1980s, industrial sector could not achieve its overall targets. During the first Three Plans, against the target of 7, 10.5 and 10.7 per cent industrial growth rate, the actual achievements were 6, 7.2, 9 per cent respectively. Since the Third Plan onwards, the gap between the targets and achievements widened.

6. Dearth of Skilled and Efficient Personnel:

The country has been facing the problem of dearth of technical and efficient personnel required for the industrial development of the country. In the absence of properly trained and skilled personnel, it has become very difficult to handle such highly sophisticated computerized machineries necessary for industrial development of the country.

7. Elite Oriented Consumption:

In recent years, a strong tendency to produce rich men's goods has been established among the large industrial houses. Accordingly, the production of "white goods" like refrigerators, washing machines, air conditioners etc. expanded substantially along with the other luxury products.

8. Concentration of Wealth:

The pattern of industrialisation in the country has been resulting in concentration of economic power in the hands of few large industrial houses and thus failed to achieve the objective of planning in reducing concentration of wealth and economic power. As for example, Tatas with 38 companies substantially increased their assets from Rs. 375 crore in 1963-64 to Rs. 14,676 crore in 1991-92.

9. Poor Performance of the Public Sector:

In spite of attaining a substantial expansion during the planning period, the performance of public sector enterprises remained all along very poor. A good number of such enterprises are incurring huge losses regularly due to its faulty pricing policy and lack of proper management necessitating huge budgetary provision every year. Thus, the public sector investment failed to generate required surpluses necessary for further investment in industrial sector of the country.

10. Regional Imbalances:

Concentration of industrial development into some few states has raised another problem of imbalances in industrial development of the country. Western region comprising Maharashtra and Gujarat attained maximum industrial development whereas the plight, of the poor states are continuously being neglected in the process of industrialisation of the country in spite of having a huge development potential of their own.

11. Industrial Sickness:

Another peculiar problem faced by the industrial sector of the country is its growing sickness due to bad and inefficient management. As per the RBI estimate, a total number of sick industrial units in India were 1,71,316 as on 31st March, 2003 and these sick industrial units had involved an outstanding bank credit to the extent of Rs. 34,815 crore.

12. Regime of State Controls:

Lastly, industrial inefficiencies resulting in perpetuation of regional state controls and regulatory mechanism are standing in the path of industrialisation of the country. In recent years, the Government has undertaken some serious measures to make necessary economic reforms in the industrial structure of both the public as well as private sectors of the country.

Causes and remedies composition and direction of foreign trade in India role of economic planning

Salient Features of Foreign Trade – Explained!

Foreign trade plays an important role in the economic development of country. It is said, “Foreign trade is not simply a device for achieving productive efficiency but is an engine of economic growth.”

Many reasons certify this statement.

- (i) Nation can optimally use its resources.
- (ii) Technical know-how can be imported.
- (iii) Surplus production can be exported.
- (iv) Machinery and raw materials can be imported as and when needed.
- (v) Food grains and necessary help can be imported during natural calamities like earthquake, & flood etc.

Salient Features of Foreign Trade:

The following are the features of foreign trade:

(i) Change in the composition of exports:

After independence many changes took place in export trade. India exported tea, jute, cloth, iron, spices and leather before independence. Now chemicals, readymade garments, gems, jewellery, electronic goods, processed foods, machines. Computer software etc. are exported along with tea, jute and cotton textiles.

(ii) Change in the composition of imports:

India imported consumer goods, medicines, textiles, motor vehicles and electrical goods before independence. After independence, imports are fertilizers, petroleum, steel, machines, industrial raw materials, edible oils and unfinished diamonds.

(iii) Direction of foreign trade:

Direction of foreign trade means those countries with which India has trade ties. Before independence, India has trade relations with England and Commonwealth Nations Now India has trade relations with U.S.A, Russia, Japan, European Union and Organization of Petroleum Exporting Countries (OPEC).

(iv) Balance of trade:

Simply speaking balance of trade means the difference between value of exports and imports. Balance of payments is favourable if exports exceed imports and un-favourable if imports exceeds export. India's balance of payment was favourable before Independence. It was favourable to Rs. 42 crore, but after independence it becomes un-favourable. It was Rs. 65741 crore adverse in 2003-04.

(v) Dependent trade:

Before independence, Indian foreign trade was dependent on foreign shipping, insurance and banking companies. After independence, cargo ships are being built in India. Banks and insurance companies have started taking interest in foreign trade.

(vi) Trade through sea routes:

India's foreign trade is through sea routes. India has very little trade relations with neighbouring countries like Nepal, Afghanistan, Pakistan, Bhutan and Sri Lanka etc.

(vii) Dependence on a few Ports:

Indian foreign trade is through Chennai, Kolkata and Mumbai ports. These ports are always over-crowded. After independence ports like Kandla, Cochin and Vishakhapatnam have been developed.

(viii) Less percentage of world trade:

India's share in world trade has been diminishing. It was 1.8% of world's total imports and 2% of world's total exports in 1950-51. In 2003-04 India's share in total world imports was 1% and in total world exports was 0.8%.

(ix) Increased Share in Gross National Income:

Foreign trade has significant contribution in Indian national income. In 1950-51, India's foreign trade contribution into national income was 12% and rose is 29% in 2003-04.

(x) Increase in value and volume of trade:

The value and volume of imports and exports increased many fold. In 1950-51 imports were Rs. 608 crores and exports were Rs. 606 crores. So total value was Rs. 1214 crores. In 2003-04, it increased to Rs. 6, 52,475 crore. Value of exports 2, 93,367 crore and of imports 3, 59,108 crore.

Economic Planning in India: Achievements and Failures

Let us make an in-depth study of the major achievements and failures of economic planning in India.

Major Accomplishments of Planning:

(a) Higher Rate of Growth:

Economic planning in India aims at bringing about rapid economic development in all sectors. In other words, it aims at a higher growth rate.

India's macroeconomic performance has been only moderately good in terms of GDP growth rates. The compound annual rate of growth stands at 4.4% at 1993-94 prices for the whole planning period (1950-51 to 1999-00). Compared to the pre-plan period when she was caught in a low level equilibrium trap, growth acceleration during the last 50 years has been impressive indeed. However that it is not yet clear as to how much of this acceleration has been due to the change in the world economic boom since World War II and how much due to India's own planning efforts.

(b) Growth of Economic Infrastructure:

India's performance in building up the necessary economic infrastructure is really praiseworthy. It is to be noted that the process of industrialisation of any country largely depends on the development of economic infrastructure in the form of transport and communications, energy, irrigation facilities, and so on.

(c) Development of Basic and Capital Goods Industries:

Another major area of success of Indian planning is the growth of basic and capital goods industries. With the adoption of the Mahalanobis strategy of development during the Second Plan period, some basic and capital goods industries like iron and steel witnessed spectacular growth.

(d) Faster Growth of Agriculture:

The most significant aspect of India's five year plans is that the overall rate of growth of food production has now exceeded the rate of growth of population. No doubt, in the early years of planning, agricultural performance was miserable. As a result there had emerged food crisis. But due to the impact of biochemical revolution from the late 1960s, food crisis has become almost a thing of the past. She has attained self-sufficiency in food-grains.

(e) Savings and Investment:

The rise in the domestic savings rate from 8.9% of GDP in 1950- 51 to 22.3% in 1999-00 is definitely impressive. Similarly, India's gross domestic capital formation increased from 8.7% in 1950-51 to 23.3% of GDP in 1999-00. However, this higher growth rate of capital formation failed to accelerate the rate of economic growth. Hence, a paradox has been encountered high saving rate and slow growth of per capita income.

(f) Economic Self-Reliance:

Self-reliance refers to the lack of dependence on external assistance. In other words, it means zero foreign aid. India all along used to importing huge food-grains, fertilisers, raw materials and industrial machinery and equipment. This resulted in draining of India's precious foreign exchange reserves. Hence, the need for achieving economic self-reliance.

Major Failures of Planning:

(a) Inadequate Growth Rate:

In quantitative terms, the growth rate of the Indian economy may be good but not satisfactory by any standards. Since the actual growth rate was less than the planned or targeted rate of growth it was not possible to meet other goals of planning such as poverty alleviation and improvement of living standards.

(b) Move Toward Socialistic Pattern of Society:

Indian planning aims at building up a 'socialistic pattern of society', in a mixed economy, through various egalitarian measures. These are (i) land reform measures with the purpose of redistribution of land among poorer peasants, (ii) reduction of concentration of economic power

in the hands of a few big bourgeoisie and (iii) expansion of the public sector and nationalisation of certain important industries.

(c) Economic Inequality and Social Injustice:

Two aspects of social justice involves, on one hand, the reduction of poverty and on the other, the reduction of inequality. Indian plans aim at reducing such inequalities, so that the benefits of economic development can be enjoyed by poor people and the weaker sections of the society.

(d) Unemployment:

The removal of unemployment is considered to be another important objective of India's five-year plans. But the employment generation programmes did not achieve much success and the problem of unemployment has become more and more serious plan after plan. The number of applicants on the live register of employment exchanges increased from 17.83 lakhs in 1981 to 40.37 lakhs in 1999.

(e) Regional Imbalance:

The entire planning exercise has created a vast regional imbalance. Over the years, inequalities among the States have widened. This is mainly because the backward areas did not receive fair treatment, so far as resource transfer is concerned.

(f) Inflation:

Finally, the benefits of economic planning have largely offset by price inflation. The prices of essential goods have been increasing much faster than other prices. This has resulted in great hardships to the vast majority of the people mainly the poor and the weak. Growth without stability has become an essential characteristic of Indian planning.