CHAPTER - 3

ECONOMIC REFORMS SINCE 1991

Since independence, India followed the mixed economic system, by combining the advantages of capitalist economy with those of the socialist economy.

☐ But in reality, the public sector dominated the control and regulation of our economy and private sector was ignored.

☐ There was a huge investment in the public sector and very low investment in the private sector.

☐ The dominance of public sector for about 4 decades led to establishment of various rules and laws, which hampered the process of growth and development.

REASONS FOR ECONOMIC REFORMS (SIDE)

1. SHORTAGE OF FOREIGN EXCHANGE RESERVES

☐ Imports grew at a very high rate without matching the growth of exports.

☐ As a result, foreign exchange reserves fell to the lowest level; there were not sufficient reserves to finance imports; even for a fortnight.

2. INEFFICIENT MANAGEMENT

☐ The constant expenditure on development programmes by the government did not generate any additional revenue.

☐ The government was not able to generate sufficient revenue from internal sources such as taxation or revenue from public sector enterprises, etc.

3. DEBTS BURDEN

☐ To meet its consumption expenditure, the government borrows from other countries and international financial institutions.

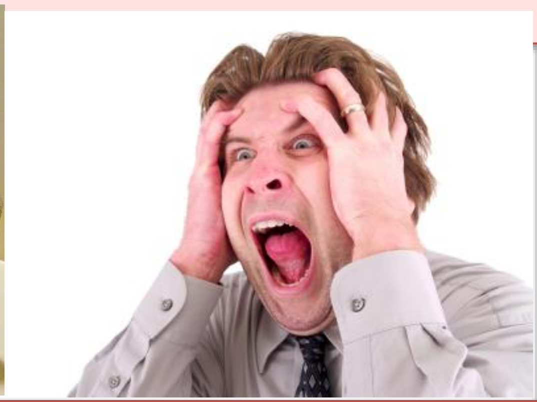
☐ Due to financial crisis, foreign exchange reserve was not sufficient to pay the interest to international lenders.

☐ adding to it, no country or international funder was willing to lend to India.

4. EFFECT OF INFLATIONARY PRESSURE

☐ Prices of many essential goods rose sharply.

☐ The rise in prices was mainly due to increase in money supply and shortage of essential goods.



ECONOMIC REFORMS

☐ To manage the crisis, the Indian Government borrowed a loan of $7 billion from World Bank and International Monetary Fund (IMF).

☐ To avail this loan, the Indian Government also agreed to the conditions of World Bank and IMF and announced the New Economic Policy by creating a more competitive environment in the economy and removed the barriers of entry and growth of firms.

☐ Removing trading restrictions between India and other countries.

☐ Eliminate restrictions on the private sector.

☐ Decrease the role of the government in many areas.

THESE SET OF POLICIES CAN BROADLY BE CLASSIFIED INTO TWO GROUPS:

1. Stabilization measures: - Or short term measures to-

☐ Correct the weaknesses in the balance of payments

☐ Bring inflation under control by maintaining sufficient foreign exchange reserves.

2. **Structural reform** policies are long-term measures, aimed at

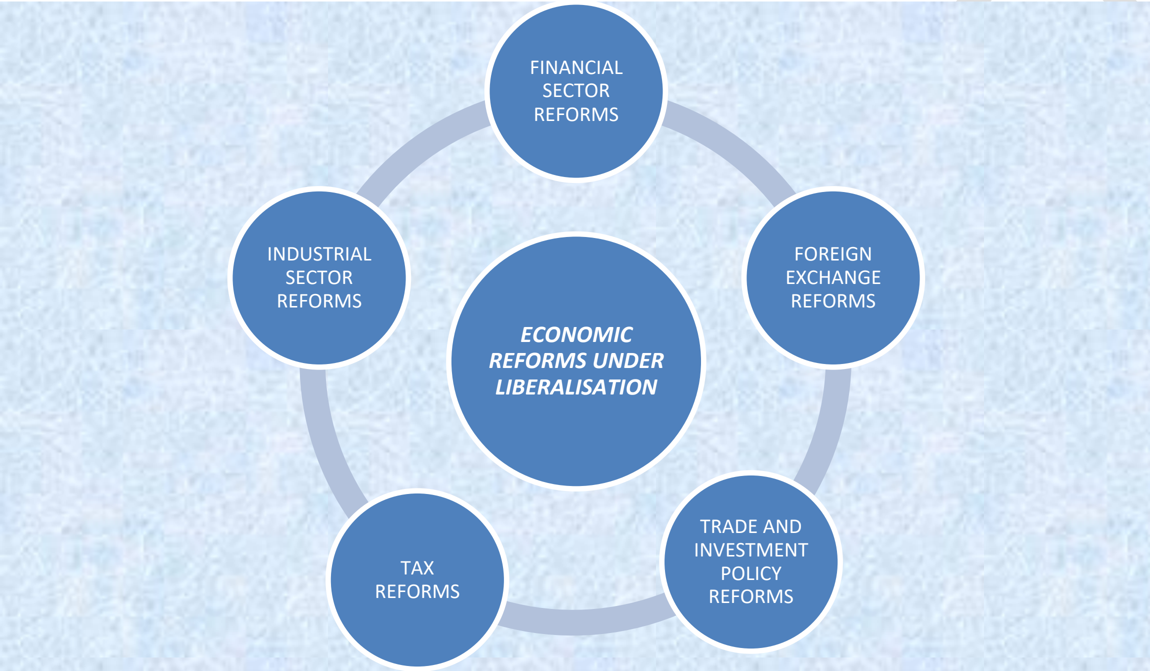
☐ Improving the efficiency of the economy

☐ Increasing its international competitiveness by removing the rigidity in various sectors.

LIBERALISATION

☐ The term liberalisation means removal of 'entry and growth' restrictions on the private sector enterprises.

☐ The purpose was to unlock the economic potential of the country by encouraging private sector and multinational corporations to invest and expand.



1. FINANCIAL SECTOR REFORMS (FARE)

It includes financial institutions, such as commercial banks, investment banks, stock exchange operations and foreign exchange market. The financial sector in India is regulated by the Reserve Bank of India (RBI).

The reforms introduced under financial sector are:

1. Foreign investment limit in banks was raised to around 51 per cent. Foreign Institutional Investors (FII) such as merchant bankers, mutual funds and pension funds were now allowed to invest in Indian financial markets.

2. Autonomy to Bank to set up new branches (after fulfilment of certain conditions) without the approval of the RBI.

3. Role of RBI (Central bank) reduced from regulator to facilitator of financial sector. As a result, the financial sector was allowed to take decisions on many matters, without consulting the RBI.

4. Establishment of private sector banks in India like ICICI Bank or HDFC Bank. This increased the competition and benefitted the consumers through lower interest rates and better services.

2. FOREIGN EXCHANGE REFORMS

In 1991; as an immediate measure to solve the balance of payments crisis, foreign exchange reforms were made.

1. Devaluation of Rupee: Devaluation refers to reduction in the value of domestic currency by the government. To overcome Balance of Payments crisis, the rupee was devalued against foreign currencies. This led to an increase in the inflow of foreign exchange.

2. Market Determination of Exchange Rate: The Government allowed rupee value to be free from its control. As a result, market forces of demand and supply determined the exchange value of the Indian rupee in terms of foreign currency.

3. INDUSTRIAL SECTOR REFORMS (DRIP)

In order to make necessary reforms in the industrial sector, the Government introduced its New Industrial Policy on July 24, 1991.

1. De-reservation under small-scale industries- Many goods produced by small scale industries were now de-reserved.

2. Reduction in role the of Public Sector: in the future industrial development of the country (reduced from 17 to 3).

(i) Defence equipment;

(ii) Atomic energy generation;

(iii) Railway Transport

3. Industrial Licensing Abolishing - No licenses were needed to set up new units, expand or diversify, except in certain areas like defence equipment, Atomic energy generation, Railway Transport.

4. Price regulation: - In many industries, the market was allowed to determine the prices through forces of the market.

4. TAX REFORMS

Tax reforms refer to reforms in government's taxation and public expenditure policies, which are collectively known as its 'Fiscal Policy'.

DIRECT TAX	INDIRECT TAX
• consist of taxes on income of individuals as well as profits of business enterprises • For example, Income tax and corporate tax.	• Indirect Taxes refer to those which affect the income and property of people. Indirect taxes are generally imposed on goods and services • For example,GST

THE MAJOR TAX REFORM (SIR)

1. Simplification of Process: In order to encourage better compliance on the part of taxpayers, many procedures have been simplified.

2. Indirect Taxes Reform: huge reform has been made in indirect taxes to facilitate establishment of common national market for goods and commodities.

3. Reduction in Taxes: Since 1991, there has been a continuous reduction in income and corporate tax as high tax rates were an important reason for tax

evasion. It is now widely accepted that moderate rates of income tax encourages savings and voluntary disclosure of income.

5. TRADE AND INVESTMENT POLICY REFORMS (FIRE)

Liberalization of trade and investment management was initiated to increase international competitiveness of industrial production and to promote foreign investments and technology into the economy.

1. Fast Removal of Quantitative restrictions on Imports and Exports: Under the New Economic Policy, quantitative restrictions on imports and exports were greatly reduced. For example, quantitative restrictions on imports of manufactured consumer goods and agricultural products were fully removed from April 2001.

2. Import Duties Reduction: Import duties were reduced to improve the position of domestic goods in the foreign market.

3. Relaxation in Import Licensing System: The Import licensing was abolished, except in case of hazardous and environmentally sensitive industries. This encouraged domestic industries to import raw materials at better prices, which raised their efficiency and made them more competitive.

4. Export Duties Removal: Export duties were removed to increase the competitive position of Indian goods in the international markets.

PRIVATISATION

Privatisation refers to the transfer of ownership, management and control of public sector enterprises to the private sector.

Privatisation can be done in two ways-

- Transfer of ownership and management of public sector companies from the government to the Private Sector.
- Privatisation of public sector undertakings (PSU) by selling off a part of the equity of PSUs to the public. This process is known as disinvestment.

Objectives: -

1. Performance improvement of the PSUs through private management.
2. Encourage Inflow of FDI: - The government predicted that privatisation could lead to inflow of FDI.
3. Autonomy:-To improve the efficiency of PSUs by giving them autonomy in taking managerial decisions.
4. Key To improve financial discipline and facilitate modernization.

GLOBALISATION

Globalisation means integrating the national economy with the world economy through removal of barriers on international trade and capital movements.

- Globalisation offers opportunity for an organization to expand globally, i.e., in worldwide market.
- Improving technologies for better transportation and communication have enabled companies to expand into worldwide markets.
- Purpose is to turn the world into one whole or creating a borderless world.

OUTSOURCING:

- This is one of the important outcomes of the globalization process. In outsourcing, a company hires regular services from external sources, mostly from other countries, which was previously provided internally or from within the country (like legal advice, computer service, advertisement).

- Most multinational corporations, and even small companies, are outsourcing their services to India where they can be availed at a cheaper cost with reasonable degree of skill and accuracy.

World Trade Organisation (WTO): The WTO was founded in 1995 as the successor organisation to the General Agreement on Trade and Tariff (GATT). GATT was established in 1948 with 23 countries as the global trade organisation.

WORLD TRADE ORGANIZATION

Objective

- The WTO agreements cover trade in goods as well as services to facilitate international trade (bilateral and multilateral) through removal of tariff as well as non-tariff barriers and providing greater market access to all member countries.

- Administer all multilateral trade agreements by providing equal opportunities to all countries in the international market for trading purposes.

- Facilitate production and trade of services, to ensure optimum utilization of world resources and to protect the environment.

- Move to establish a rule-based trading regime in which nations cannot place restrictions on trade.

ARGUMENTS IN FAVOUR OF ECONOMIC REFORMS (CIRCUS)

1. Control on Inflation: Increase in production, tax reforms and other reforms helped in controlling the inflation. The annual rate of inflation reduced from the peak level of 17 % in 1991 to around 7.6 % in 2012-13.

2. Inflow of foreign Investment: The opening up of economy has led to rapid increase in foreign direct investment (FDI). The foreign investment (FDI and foreign institutional investment) increased from about US 100 million dollar in 1990-91 to US 150 billion dollar in 2003-04.

3. Rise in Foreign Exchange Reserves:

- The foreign investment, which includes foreign direct investment (FDI) and foreign institutional investment (FII), has increased from about US $100 million in 1990-91 to US $ 73.5 billion in2014-15.

- There has been an increase in the foreign exchange reserves from about US $ 6 billion in 1990-91 to about US $ 321 billion in 2014-15.India is one of the largest foreign exchange reserve holders in the world.

4. Concern for Increase in role of private Sector: Abolition of licensing system and removal of restrictions on entry of the private sector, in areas earlier reserved for the public sector, have enlarged the area of operation of the private sector.

5. Up rise in rate of Economic Growth:

- The growth of GDP increased from 5.6 percent during 1980–91 to 8.2 % during 2007–12. This shows that there has been an increase in the overall GDP growth in the reform period.

- During the reform period, the growth of agriculture and industrial sectors has declined, whereas the growth of service sector has gone up. This indicates that the growth is mainly driven by the growth in the service sector.

6. Surge in Exports: During the reform period, India experienced considerable increase in exports of auto parts, engineering goods, IT software and textiles.

CRITICISM OF ECONOMIC REFORMS

1. Growth in Agriculture- The new economic policy has neglected the agricultural sector as compared to industry, trade and services sector.

- Policy changes:-

☐ Reduction in import duties on agricultural products;

☐ Removal of minimum support price;

☐ Lifting of quantitative restrictions on agricultural products.

- Effects:-

❖ Adversely affected the Indian farmers as they have to face increased international competition.

❖ Reduction of public investment: Public investment in agriculture sector, especially in infrastructure, which includes irrigation, power, roads market linkages and research and extension (which played a crucial role in the Green Revolution), has been reduced in the reform period.

❖ Export-oriented policy: Due to Export-oriented policy strategies in agriculture, the production shifted from food grains to cash crops for the export market. It led to rise in the prices of food grains.

❖ Subsidy Removal of subsidy: Removal of fertilizer subsidy increased the cost of production, which adversely affected the small and marginal farmers.

2. Reform in Industry: Industrial growth recorded a slowdown due to the following reasons:

❖ Cheaper Imported Goods: Due to globalisation, there was a greater flow of goods and capital from developed countries and as a result, domestic industries were exposed to imported goods. Cheaper imports replaced the demand for domestic goods and domestic manufacturers started facing competition from imports.

❖ Lack of infrastructure facilities: The infrastructure facilities, including power supply, have remained inadequate due to lack of investment.

❖ Non-tariff Barriers by Developed countries: All quota restrictions on exports of textiles and clothing have been removed from India. But some developed countries, like USA have not removed their quota restrictions on import of textiles from India.

3. Employment and Growth: Though the GDP growth rate has increased in the reform period, but such growth failed to generate sufficient employment opportunities in the country.

4. Economic Reform and Fiscal Policy: The tax reduction in the reform period was done to generate larger revenue and to curb tax evasion. But, it did not result in increase in tax revenue for the government. Reasons-

- Tariff reduction decreased the scope for raising revenue through customs duties.
- Tax incentives provided to foreign investors to attract foreign investment further reduced the scope for raising tax revenues.

5. Disinvestment: According to some scholars, the disinvestment policy was not successful because:

- The assets of public sector undertakings (PSUs) were under-valued and sold to the private sector.
- Such proceeds from disinvestments were used to compensate shortage of government revenues rather than using it for the development of PSUs and building social infrastructure in the country.

Q1. What is Goods and Services Tax (GST)? State its aim and features. (4)

Ans. The Parliament passed a law, Goods and Services Tax Act, 2016, to simplify and introduce a unified indirect tax system in India. This law came into effect from 1 July 2017.

It aims to generate additional revenue for the government; to reduce tax evasion; and to create 'one nation, one tax and one market'.

Features:

1. Single comprehensive indirect tax on supply of goods and services, right from the manufacturer/service provider to the consumer.

2. Applicable throughout the country with one rate for one type of goods/service. Under GST, there are 5 (five) standard rates applied, i.e. 0%, 5%, 12%, 18% and 28% on supply of all goods and services across the country.

3. It has replaced large number of taxes on goods and services levied on production/sale of goods or provision of service, e.g. Central Excise Duty, Service Tax, VAT/Sales Tax, Entertainment Tax, etc.

4. Some of the major taxes levied by the Central Government which have been subsumed in GST are- Central Excise Duty, Service Tax, Central Sales Tax, etc.

Q2. State the benefits of Goods and Services Tax (GST) on the Indian economy. (4)

Ans. Benefits of GST on the Indian Economy are- (BEAT)

1. Boost in GDP: - It has resulted into higher economic growth as GDP is expected to rise by about 2%.

2. Ease in filing: - Compliance will also be easier as all tax payment related services like registration, returns, and payments are available online.

3. Advantages to consumers:- It has facilitated the freedom of movement of goods and services and created a common market in the country. It is aimed at reducing cascading effect of various taxes on consumers.

4. Transparency: - It has expanded the tax base, introduced higher transparency in the taxation system, reduced human interface between Taxpayer and Government and increased ease of doing business.

Q3. Write a short on demonetization.

Ans. The Government of India, made an announcement on November 8, 2016 with thoughtful implications for the Indian economy.

- The two largest denomination notes, Rs 500 Rs 1,000, were 'demonetized' with immediate effect, ceasing to be legal tender except for a few specified purposes such as paying utility bills.

- This led to 86%% of the money in circulation invalid.

- The people of India had to deposit the invalid currency in the banks which came along with the restrictions placed on cash withdrawals.

Q4. "The demonetisation of currency undertaken by the Government of India on November 8, 2016 had an adverse impact on the economic activities." Do you agree with the statement? Give reason in support of your answer. (4)

Ans. (FACTS)

1. Form a less-cash or cash-lite economy: - Channelling more savings through the formal financial system and improving tax compliance.

2. Adding savings into the formal financial system: - Though, much of the cash that has been deposited in the banking system is bound to be withdrawn but some of the new deposits schemes offered by the banks will continue to provide a base loan, at lower interest rates.

3. Check on tax evasion: - indicating that tax evasion will no longer be tolerated or accepted.

4. Tax administration measure: - Cash holdings arising from declared income was deposited in banks and exchanged for new notes. But those with black money had to declare their unaccounted wealth and pay taxes at a penalty rate.

5. Solving corruption: - the problem of corruption was solved due to demonetization.

Q5. State the impact of demonetization.

Ans. Impact of demonetization is as follows-

1. Money/Interest rates
   - ☐ Decline in cash transactions
   - ☐ Bank deposits increased
   - ☐ Increase in financial savings

2. Private wealth declined- since some high demonetized notes were not returned and real estate prices fell.

3. There was no such effect on public sector.

4. Digitization Digital transactions amongst new users (RuPay/AEPS) increased.

5. Real estate Prices declined.

6. Tax collection- Rise in income tax collection because of increased disclosure adapted from Economic Survey, 2016–17