Chapter - 4. NCERT

❖Definitions-

Ex-ante **(planned)**	depicts what has been planned.
Ex-post **(achieved)**	depicts what has actually happened.
Marginal propensity to consume (MPC): **change in consump / change in income**	it is the change in consumption per unit change in income. It is denoted by c.
Marginal propensity to save (MPS): **change in savings /change in income**	it is the change in savings per unit change in income. It is denoted by s and is equal to 1− c .
Average propensity to consume (APC): **consump/income**	it is the consumption per unit of income.
Average propensity to save (APS**) savings / income**	it is the savings per unit of income.
Full employment level of income **Land, lab, capi, entre..all working.**	It is that level of income where all the factors of production are fully employed in the production process.
Paradox of Thrift **(more savings in economy → less income generation)**	People save more→ they consume less→ it reduces demand in economy→ it reduces profits of corporations→ they cut wages and jobs → less income to people. If all the people of the economy increase the proportion of income they save, the total value of savings in the economy will not increase – it will either decline or remain unchanged.
Autonomous Expenditure *(***essential - food, clothing. salaries***)*	This type of spending is considered automatic and necessary, whether occurring at the government level or the individual level. They have to be made no matter what the income is. Ex. For individuals- food, clothing expenses. For Govt. - Salaries, defense, law and order expenses. Any rise in autonomous expenditures will create at least an equivalent rise in GDP. This is Autonomous expenditure multiplier
Induced expenditures/consumption **Increase with increased income.**	Expenditures other than autonomous one. With rise or fall in income, these expenses change. Ex. Entertainment, branded clothes.
Aggregate demand (AD) or domestic final demand (DFD) **AD= C+G+I+X-M= GDP**	It is the total demand for final goods and services in an economy at a given time. It is also called effective demand. In a way it is the demand for the gross domestic product of a country. AD= C+G+I+X-M

	Consumer spending, investment, corporate and government expenditure, and net exports make up the aggregate demand.
Aggregate Supply **The total output or GDP**	Aggregate supply, also known as total output, is the total supply of goods and services produced within an economy at a given overall price in a given period usually a year. Aggregate supply or the total output—in other words is real GDP— that firms will produce and sell.
Investment **Adding physical/financial capital**	**Investment** is defined as addition to the stock of physical capital (such as machines, buildings, roads etc., i.e. anything that adds to the future productive capacity of the economy) and changes in the inventory (or the stock of finished goods) of a producer.
The Income Multiplier Mechanism **income→production**	Increase in income→ increase in consumption → increase in aggregate demand in the economy → increase in Production
The Investment multiplier **investment→production**	Increase in investment—> increase in Production.

❖ BANKING.

ASSETS AND LIABILITIES OF BANKS.

Assets Assets are things a firm owns or what a firm can **claim from others.** In case of a bank, apart from buildings, furniture, etc., its assets are loans given to public. **Reserves** are deposits which commercial banks keep the RBI and its cash. These reserves are kept partly as cash and partly in the form of financial instruments (bonds and treasury bills) issued by the RBI. **Assets = Reserves + Loans**	**Liabilities** Liabilities for any firm are its debts or what it owes to others. For a bank, the main liability is the deposits which people keep with it. **Liabilities = Deposits and debts**. Net Worth = Assets – Liabilities

RESERVE BANK OF INDIA

LIABILITIES	ASSETS
Notes in circulation	Foreign currency assets
Notes held in banking dept	Bill purchases and discounts
Deposits	Collaterals by commercial banks
Other liabilities	Loan and advances Rupee securities

NOTE- when central bank promises "to pay bearer the sum of this many rupees", currency becomes an "anonymous bearer bond with zero interest".	Gold coin bullion

CLASSIFICATION OF BANK'S CAPITAL

TIER I CAPITAL (CORE CAPITAL) Used in CAR (SLR, shares,secured loans.)	• Tier 1 capital is a term used to describe the capital adequacy of a bank. It is a core measure of a bank's financial strength. • It consists of money kept as Statutory Liquidity Ratio (SLR), in physical cash form as share capital and secured loans. • At least 6% of CAR must come from Tier 1 capital. This capital can absorb losses without the bank ceasing its trading operations. It consists financial capital which are in are most reliable and liquid (share capital and **disclosed reserves**)
TIER II CAPITAL (SUPPLEMENTARY CAPITAL) (retail income,unsecured loans)	It includes after tax income, retail earnings of the bank, capital in the form of bonds/hybrid instruments & unsecured loans (getting serviced). It is secondary bank capital (second most reliable form of capital)

EXTRA POINTS ON RBI

RBI as lender of last resort - (when nobody is providing money to a bank/financial institution or other, RBI provides it.)
A lender of last resort (LOLR) is the institution in a financial system that acts as the provider of liquidity to a financial institution which finds itself unable to obtain sufficient liquidity in the interbank lending market when other facilities or such sources have been exhausted.

PUBLICATIONS OF RBI	SUBSIDIARIES OF RBI
1. Report on Trend and Progress of Banking in India-Annually 2. **Financial stability** report- Half yearly 3. Monetary policy report- Half yearly 4. Report on foreign exchange reserves- Half yearly 5. Bi-monthly Policy Statement **6. Industrial Outlook Survey of the Manufacturing Sector (Quarterly)** **7. Consumer Confidence Survey (Quarterly)** 8. Report on Financial Review	• Deposit Insurance and Credit Guarantee Corporation (DICGC) • Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL) • Reserve Bank Information Technology Private Ltd. (ReBIT) • Indian Financial Technology And Allied Services (IFTAS) ASSISTIVE BODIES IN RBI – Board of Financial Supervision (BFS) and Board for Payment and Settlement Systems (BPSS); Both of these are chaired by RBI Governor.

INDEPENDENCE OF THE RBI

• Under section 7 of the RBI Act 1934, the central government may from time to time give such directions to the RBI as it may, after consultation with the Governor of the Bank, considered necessary in the public interest. Moreover, there is no legal act mandating autonomy of the RBI. • However, RBI is not only vested with the powers to formulate the monetary policy but also to monitor the functioning of all banks. • To play its role effectively, autonomy in its functioning is sine qua non for RBI. • However, this has been challenged many times due to a continued tug of war for wresting more power between the bank and the govt. **SECTION 7 OF RBI ACT, 1935** Section 7 of the RBI Act 1934 empowers the central government to supersede the RBI Board and issue directions to the RBI, after consulting the governor, if they are considered to be “necessary in public interest”.	**REASONS FOR DIMINISHING AUTONOMY OF RBI** • Clash between short term populist agenda of the government and long term view for price stability taken by RBI. • check the growth of NPAs. • Reduced liquidity in the economy due to tight monetary policy followed by RBI. • Corrective measures taken by RBI to clean up the banking system which are not seen very positively by the government. • **Impossible trinity of RBI- capital mobility, Exchange rate flexibility and monetary autonomy.** • One important limitation is that the Reserve Bank is statutorily limited in undertaking the full scope of actions against public sector banks (PSBs). • Erosion of statutory powers of the central bank through piece-meal legislative amendments that directly or indirectly eat away separation of the central bank from the government.

RBI and GOVERNMENT

TRANSFER OF FUNDS BY RBI TO CENTRAL GOVERNMENT

• Section 47 of the RBI Act 1934 requires RBI to transfer the profit it earns to the Central Government every year. • However RBI maintains various reserves in the form of capital to cover various risks including market risk, operational risk, credit risk and contingency risk.	**RBI V/S GOVT: HOW MUCH RESERVE SHOULD BE MAINTAINED?** • The surplus maintained by RBI has 2 components: – Part of net profits every year – Surplus already accumulated over the years • While RBI has been keeping a substantial part of its net profits as reserves till 2013, since 2014 RBI has been transferring 100% of its net profit to the government.
Components of RBI’s capital reserve include: • Contingency Fund – set apart for meeting the unforeseen contingencies. • Asset Development Fund – To fund investments in subsidiaries. • Currency and Gold Revaluation Account – To cover fluctuations in gold and currency assets that RBI holds. • Investment Revaluation Account (IRA) – To cover risks associated with fluctuations of interest rates of government securities.	**ECONOMIC CAPITAL FRAMEWORK for RBI** • It measures how much capital is needed by RBI to cover various risks. (**CAR for RBI**) under the Reserve Bank of India Act. • It is argued that RBI has become the most capitalized central bank in the world and has been stocking surplus capital over what is actually required to face contingency situations. • While the central banks across the world have a surplus capital to the tune of 10-14% of their

• Foreign Exchange Forward Contracts Valuation Account – To cover risks related to foreign exchange related forward contracts.	total assets, RBI 26.8% of its total assets as reserves. • Usha Thorat Committee (2004): RBI should maintain 18% of its total assets as reserves. • Malegam Committee (2014): Should transfer all entire net profits annually to RBI.

COINS AND CURRENCY

DECIMALIZATION OF COINAGE **anna to paisa.**	• **During time of independence, the basic unit of Indian currency was 1 Rupee which could be divided into 16 Annas or 64 pice (pice was old spelling of paise)** • **This 16 Anna or 64 Pice structure remained till 1957, when decimalization of the coinage was done.** • **Henceforth, spelling of "pice" was changed to "Paisa" and 1 Rupee was divided into 100 Paise. This is called Decimalization of Coinage and it took place in 1957. The 100th part of Rupee was now called Naya Paisa. The term "naya" was dropped in 1964.**
DISTRIBUTION **By RBI**	• The distribution of Coins is undertaken by RBI as an agent of the Government, (coins are minted by the Government and not by RBI). • However, the RBI is the only source of legal tender money because distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government.
SIGNATURE ON CURRENCY NOTES **1rs.-finance secy**	• Under Section 22 of the Reserve Bank of India Act, RBI has sole right to issue currency notes of various denominations except one rupee notes. • Signature on currency notes is of the incumbent RBI Governor. • The One Rupee note is issued by Ministry of Finance and it bears the signatures of Finance Secretary.
CURRENCY CHESTS **Storehouses, near banks.**	• Currency chests are storehouses where bank notes and rupee coins are stocked on behalf of the Reserve Bank. • The currency chests have been established with State Bank of India, six associate banks, nationalized banks, private sector banks, a foreign bank, a state cooperative bank and a regional rural bank. • Deposits into the currency chest are treated as reserves with the Reserve Bank and are included in the Cash Reserve Ratio.
Four printing presses **Nasik ka SDM**	• Dewas in Madhya Pradesh, • Nasik in Maharashtra, • Mysore in Karnataka, and • Salboni in West Bengal
Coins **Issue-gov** **Circulation-rbi**	• The Government of India is the issuing authority of coins and supplies coins to the Reserve Bank on demand • The Reserve Bank puts the coins into circulation on behalf of the Central Government

Bharatiya Reserve Bank Note Mudran Private Limited	• The presses in Karnataka and West Bengal are owned by the Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL), a wholly owned subsidiary of the Reserve Bank
LANGUAGES ON CURRENCY NOTES **15+hindi+eng.**	• The amount of a banknote is written on it in 17 (15 in panel on backside + Hindi + English) languages. • The 15 languages in the panel are Assamese, Bengali, Gujarati, Kannada, Kashmiri, Konkani, Malayalam, Marathi, Nepali, Oriya, Punjabi, Sanskrit, Tamil, Telugu and Urdu.
DECIMALIZATION OF COINAGE **anna to paisa.**	• During time of independence, the basic unit of Indian currency was 1 Rupee which could be divided into 16 Annas or 64 pice (pice was old spelling of paise) • This 16 Anna or 64 Pice structure remained till 1957, when decimalization of the coinage was done. • Henceforth, spelling of "pice" was changed to "Paisa" and 1 Rupee was divided into 100 Paise. This is called Decimalization of Coinage and it took place in 1957. The 100th part of Rupee was now called Naya Paisa. The term "naya" was dropped in 1964.

TYPES OF BANKS

MUDRA BANKS • MUDRA, which stands for Micro Units Development & Refinance Agency Ltd., is a financial institution set up by the Government. • It was launched by the government in 2015 for providing loans up to Rs. 10 lakh to the non-corporate, non-farm small/micro-enterprises. • Loans are provided through refinance route (through the Public and private sector banks, NBFCs, MFIs, RRBs, District Banks, etc).	• MUDRA does not lend directly to micro-entrepreneurs/individuals. • MUDRA bank is a subsidiary of SIDBI. • it does not refinance the agriculture sector. • Loans under this scheme are collateral-free loans. • Interest rates on the loans are supposed to vary according to the risk involved in the enterprises seeking loans. • There is no general subsidy offered on interest rates except if the loan is linked to some other government scheme.
TYPES OF LOAN • Shishu: upto 50,000 • Kishor: 50k- 5 lakh • Tarun: 5 - 10 lakh	• **The loans are basically for people having a business plan in a Non-Farming Sector with Income generating activities like the following:** ○ Manufacturing ○ Processing ○ Trade ○ Service Sector ○ Or any other fields whose credit demand is less than ₹10 lakhs.

Q. Pradhan Mantri MUDRA Yojana is aimed at ______ (CSE-2016)

a. bringing the small entrepreneurs into formal financial system
b. providing loans to poor farmers for cultivating particular crops
c. providing pensions to old and destitute persons
d. funding the voluntary organizations involved in the promotion of skill development and employment generation

EXPORT-IMPORT BANK OF INDIA (EXIM)

EXPORT-IMPORT BANK OF INDIA (EXIM)	Financial Products By EXIM
• EXIM of India is the premier export finance institution in India, established in 1982. • EXIM Bank is a wholly-owned subsidiary of the Indian Government. • It plays a crucial role in helping Indian companies do business abroad and bring in foreign exchange.	• Buyer's credit – offering credit to overseas buyers to import goods from India. • Export financing • Overseas investment finance • Project exports – encourages project based exports from India and helps Indian companies secure contracts abroad.
Concessional Finance Scheme (CFS)	**Services offered By EXIM**
• Under the CFS, the GoI has been supporting Indian Entities bidding for strategically important infrastructure projects abroad • operated through EXIM Bank of India.	• Marketing advisory services • assists in identifying opportunities abroad • Research and analysis – • Export advisory services –

NABARD- National Bank for Agriculture and Rural Development

NABARD	FUNCTIONS OF NABARD
• National Bank for Agriculture and Rural Development (NABARD) is an apex development financial institution in India to provide refinance for agriculture and rural development. • It does not grant Direct credit to Rural Households. • It is a statutory body established in 1982. Its headquarter is located in Mumbai. • NABARD today is fully owned by the Government of India. • NABARD is also known for its "SHG Bank Linkage Programme" (1992) which encourages India's banks to lend to SHGs. • It is responsible for the development of the small industries, cottage industries, and any other such village or rural projects. • The Bank has been entrusted with "matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India". • NABARD also does Natural Resource Management Programmes involving diverse fields like Watershed Development, Tribal Development and Farm Innovation through dedicated funds set up for the purpose. • It is one of the premier agencies providing developmental credit in rural areas.	• promotion and development, refinancing, financing, planning, monitoring and supervision. • Promotional and developmental initiatives in the areas of farm, off-farm, micro finance, financial inclusion, Convergence with Govt sponsored programmes. • Supporting the financial inclusion efforts of RRBs and Cooperative Banks • Loans to State Governments for developing rural infrastructure and strengthening of the Cooperative Credit Structure • Refinance to Rural Financial Institutions for investment credit (long term loan) and production and marketing credit (short term loan) purposes for farm and off-farm activities in rural areas. • Assist in policy formulation of GoI, RBI and State Governments on matters related to agricultural credit and rural development • Credit Planning and Monitoring, Coordination with various agencies and institutions.

Refinance facility by NABARD is available to -	RURAL INFRASTRUCTURE DEVELOPMENT FUND
• State co-operative agriculture and rural development banks (SCARDBs), • State co-operative banks (SCBs), • Regional rural banks (RRBs), • Commercial banks (CBs) and • Other financial institutions approved by RBI.	Fund is maintained by the NABARD. Banks which are not able to meet their targets of PSL are required to keep the shortfall in RIDF. **Long Term Irrigation Fund (LTIF)**- for funding and fast tracking the implementation of incomplete major and medium irrigation projects.

Q. Which of the following grants/grant direct credit assistance to rural households? (2013)

1) Regional Rural Banks 2) NABARD 3) Land Development Banks

Select Answer Codes below:

a) 1 and 2 only b) 2 only c) 1 and 3 only d) 1, 2 and 3

NATIONAL HOUSING BANK (NHB)	SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)
• NHB is an apex financial institution for housing set up in 1988. • Originally owned by RBI (100%). But in 2019, RBI sold 100% to the Government. • NHB registers, regulates and supervises Housing Finance Company (HFCs), keeps surveillance through On-site & Off-site Mechanisms and co-ordinates with other Regulators. **NHB Residex** – It is a set of benchmarks that aims to track housing price indicators across Indian cities.	• SIDBI set up in 1990 under an Act of Parliament, acts as the Principal Financial Institution for Promotion, Financing and Development of the MSME sector as well as for coordination of functions of institutions engaged in similar activities • Shareholding in SIDBI– GOI + SBI + LIC + NABARD + Others
• NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.	• Initiatives by SIDBI – Udyog Aadhar (MSME), Udyami Mitra portal, Guarantee fund, Small Enterprises Development Fund (SEDF). • SIDBI is one of the four Financial institutions regulated and supervised by the RBI (other three are EXIM Bank, NABARD and NHB)

Q. Find Correct Statement/s (CSE-2004)

1. NHB, the apex institution of housing finance in India, was set up as a wholly owned subsidiary of RBI.
2. Small industries development bank of India was established as a wholly owned subsidiary of the Industrial development bank of India (IDBI).

a) Both 1 and 2 b) Neither 1 nor 2 c) 1 d) 2

WAYS AND MEANS OF ADVANCES (WMA) (temporary loans by RBI to centre and states)	• The RBI gives temporary loan facilities to the centre and state governments as a banker to the government. This temporary loan facility is called WMA. • It is a mechanism provided to States to help them tide over temporary mismatches in the cash flow of their receipts and payments. • It was introduced in 1997, after putting an end to the four-decade-old system of ad-hoc (temporary) Treasury Bills to finance the Central Government deficit. • Under Section 17(5) of RBI Act, 1934, the RBI provides Ways and Means Advances (WMA) to the central and State/UT governments.
WAYS TO AVAIL WMA (@repo rate,mutually decided limit, repay in 90 days)	• This facility can be availed by the government if it needs immediate cash from the RBI. • The WMA is to be vacated after 90 days. • The interest rate for WMA is currently charged at the repo rate. • The limits for WMA are mutually decided by the RBI and the Government of India.
TYPES OF WMA 1. Normal- based on revenue and capital. 2. Special-against G-securities as collateral.	• Special WMA or Special Drawing Facility is provided against the collateral of the government securities held by the state. • The interest rate for SDF is one percentage point less than the repo rate. • After the state has exhausted the limit of SDF, it gets normal WMA. The number of loans under normal WMA is based on a three-year average of actual revenue and capital expenditure of the state. • The RBI has raised the Ways and Means Advances, or WMA, limit by 30% for all States and UTs to enable them to tide over the crisis caused by COVID-19 outbreak.

DIFFERENT TYPES OF LOANS At present, interest rates on loans are linked to a bank's marginal cost of fund-based interest rate, known as the Marginal Cost of Lending Rate (MCLR).	
Fixed Interest **Fixed EMI**	repayment of loans in fixed equal instalments over the entire period of the loan. In this case, the interest rate doesn't change with market fluctuations
Floating Interest rate **changing EMI**	rate of interest varies with market conditions. The drawback with floating interest rates is the uneven nature of monthly instalments.
Teaser Loan **Initially low, later high interest rates.**	A sub-type of floating interest rate loan, wherein initial years have low interest, but afterwards higher interest rate. While RBI has not banned Teaser loans but has put stricter regulations on them from 2011.

TYPES OF BORROWERS	
Prime Borrower	**Borrower has the capacity to repay loans**
Subprime Borrower Can't repay	Such borrower doesn't have the capacity to repay loan. Giving teaser rate home loans to subprime borrowers was among the reasons for the Subprime Crisis in the USA (2007-08), which ultimately led to the Global Financial Crisis.
Overleveraged Borrower Too much debt.	Such a company has borrowed too much money than its ability to pay it back. An Overleveraged company has a high ratio of Debt (Bonds/loans) to Equity (Shares).

Zombie Lending Risky lending by weak bank.	When a weak bank keeps giving new loans to a subprime / over leveraged borrower. (means bank is taking risk without considering anything. It happens due to irregularities and poor surveillance)

Universal banking (all services, all customers)	NARROW BANKING (no risky investments)
• It is defined as a banking system that offers a wide range of banking and financial services (like insurance, development banking, investment banking, commercial banking, and other financial services) in comparison to traditional banking institutions • It provide all three services that is retail banking, investment banking, and wholesale banking. • This system offers asset management, deposits, payment processing, investment advisory, underwriting, securities transactions, financial analysis, merchant banking, factoring, mutual funds, credit cards, auto loans, insurance, housing finance, retail loans, etc.	• Narrow risk taking, banks invest only in safe options. • Narrow Banking is very much an antonym to Universal Banking. • Narrow Banking means Narrow in the sense of engagement of funds and not in activity. • So, simply, Narrow Banking involves mobilizing the large part of the deposits in Risk Free assets such as Government Securities.

SPECIAL MENTION ACCOUNTS (SMA) Stressed accounts To be NPAs 30, 60, 90/ 0, 1, 2	• It is a tool for early stress discovery of bank loans. Introduced as a corrective action plan. • According to the stress level such loans are categorized into three categories based on delays in interest payment. • SMA 0 (Delay up to 30 Days) • SMA 1 (Delay up to 31-60 Days) • SMA 2 (Delay up to 61-90 Days)
Strategic Debt Restructuring (SDR) Debt→ equity	• The Strategic Debt Restructuring (SDR) is an attempt to revive stalled projects by giving equity participation to banks in such projects. • Converting debt to equity is the main approach under the SDR.
"CAMELS" model Capi, asset, mgmt, Earning, liquidity, sensitivity.	• CAMELS stands for Capital adequacy, Asset quality, Management, Earning and Liquidity and Sensitivity. • As a tool it is very effective, efficient and accurate to be used in performance evaluation in banking industries and to anticipate the future and relative risk.
RBI'S PRUDENTIAL FRAMEWORK FOR RESOLUTION OF STRESSED ASSETS (PFRSA) Early resolution plan, inter-creditor agreement.	• PFRSA provides for early resolution of stressed assets in a transparent and time-bound manner by-Giving complete discretion to lenders with regard to design and implementation of resolution plans, • Disincentives for delay in implementation of resolution plan or initiation of insolvency proceedings, • Making mandatory the signing of an inter-creditor agreement, providing for majority decision- making by all lenders.
UTKARSH FRAMEWORK 2022 Excellent working by RBI	• RBI launched 'Utkarsh 2022', the Reserve Bank of India's Medium- term Strategy Framework to achieve excellence in the performance of RBI's mandates and strengthening the trust of citizens and other institutions.

	• It is a three-year road map for medium term objective which is in line with the global central banks' plan to strengthen the regulatory and supervisory mechanism.
Project Sashakt 50cr- bank 500cr.- inter creditor agreement or NCLT >500cr. - Asset management company.	• It is to help consolidate stressed assets. • Bad loans of up to ₹ 50 crore will be managed at the bank level. • For bad loans of ₹ 50-500 crore, banks will enter an inter-creditor agreement, authorizing the lead bank to implement a resolution plan in 180 days, or refer the asset to NCLT. • For loans above ₹ 500 crore, the panel recom-mended an independent AMC (asset management company).
INTER CREDITOR AGREEMENT (ICA) (group lenders resolving loan. 50cr, Sashakt). **Asset Reconstruction Company** Buys NPAs	• The agreement for resolution of loan accounts which are under the control of a group of lenders, and the size of those accounts are Rs 50 crores or above is known as intercreditor agreement. • An Asset Reconstruction Company is a specialized financial institution that buys the NPAs or bad assets from banks and financial institutions so that the latter can clean up their balance sheets. In other words, ARCs are in the business of buying bad loans from banks. Its is also called bad bank. Ex. NARCL national asset reconstruction company ltd.
S4A SCHEME >500cr. Loan Convert unsustainable debt into equity. Borrowers retain management.	• Scheme for Sustainable Structuring of Stressed Assets • Introduced in 2016, in it an independent agency is hired by the banks which decides as how much of the stressed debt of a company is 'sustainable'. • The rest ('unsustainable') is converted into equity and preference shares. • an account is considered eligible for restructuring if the total loans in the account by all the institutional lenders exceeds Rs. 500 crore • Under the S4A Scheme, banks would be to allow existing promoters to continue in the management even while being a minority shareholder. Whereas in the case of SDR strategic debt restructuring, the promoter is delinked and ownership is changed.

Q. 'Scheme for Sustainable Structuring of Stressed Assets (S4A)' is related to____ (CSE-2017)

a. Procedure for ecological costs of developmental schemes.
b. Scheme of RBI for reworking the financial structure of big corporates with genuine difficulties.
c. Disinvestment plan for Central Public Sector Undertakings.
d. Provision in 'The Insolvency and Bankruptcy Code'.

Q. What was the purpose of Inter-Creditor Agreement signed by Indian Banks and financial institutions recently? (CSE-2019)

a. To lessen the Government of India's perennial burden of fiscal deficit and current account deficit
b. To support the infrastructure projects of Central and State governments
c. To act as independent regulator in case of applications for loans of INR 50 cr or more
d. To aim at faster resolution of stressed assets of INR 50 cr or more which are under consortium lending

BANKING OMBUDSMAN

RBI'S BANKING OMBUDSMAN SCHEME	Customers can approach Banking Ombudsman for grievance redressal in the following areas:
• Quasi-judicial authority created to resolve customer complaints against banks, introduced under the Banking Regulation Act in 1995. • The Ombudsman is a senior official appointed by RBI. It covers all types of banks. **INTERNAL OMBUDSMAN** • Internal Ombudsman: Commercial banks having 10 or more banking outlets should have an independent internal ombudsman (IO). • Fixed Term: 3-5 Years • Removal: The IO can be removed only with prior approval from RBI. • Compensation limit: allowed for complaints where the compensation amount for any loss suffered by the complainant is limited to Rs 20 lakh. • Additionally, maximum compensation of Rs 1 lakh for loss of time and money, harassment and mental anguish suffered by the complainant.	• Non-payment/ delay in the payment or collection of cheques, drafts, bills etc. • Non-payment/delay in payment of inward remittances • Failure/delay to issue drafts, pay orders or bankers' cheques • Non-adherence to prescribed working hours • Refusal to open deposit accounts without any valid reason • Levying of charges without adequate prior notice to the customer • Refusal/delay in closing the accounts • Non-observance of RBI guidelines on engagement of recovery agents by banks • In 2018, mis-selling of 3rd party products like insurance was added. **Note -** Ombudsman scheme for NBFCs 2018 – Extended to redressal of complaints against NBFCs in 2018.

DEFINITIONS AND DESCRIPTIONS

BANK RUN (mass withdrawal)	A bank run is a type of financial crisis. It is a panic which occurs when a large number of customers of a bank fear it is insolvent and withdraw their deposits.
NO FRILLS ACCOUNTS (zero balance/charges)	Account either with nil or very low minimum balance as well as charges that would make such accounts accessible to vast sections of population along with extending financial inclusion. Ex. jan dhan accounts
BANK STRESS TEST (balance sheet evaluation)	• A stress test is an assessment or evaluation of a Bank's balance sheet to determine if it is viable as a business or likely to go bankrupt when faced with certain recessionary and other stress situations- whether it has sufficient capital buffers to withstand the recession and financial crisis. • European banks were recently subjected to such stress tests.
EVERGREENING OF THE LOAN (loan to repay loan)	• Evergreening in banking is a practice of providing a fresh loan to repay an old loan. For example, a bank can lend money to a company to pay another bank's loan. • In this way, the first bank can maintain its balance sheet and reduce its non-performing assets (NPAs).
LAND DEVELOPMENT BANKS	These are banks which provide long term loans to promote use of land, agriculture etc.
CONSORTIUM LENDING (several banks finance a borrower.)	• It is good to provide large sum of money

	• However, it has often led to delays in loan appraisal because of inability of banks to share data with each other in timely manner which delays funding for borrowers. • It also resulted in adding more non-performing assets (NPAs) to the banking system
PRO-CYCLICAL LENDING (Boom-high lending at low rates slowdown - less lending)	banks keep the lending rates low & reduce buffers during an economic boom and therefore, promote increase in the credit uptake. Similarly, they lend less during a recession.
COUNTER – CYCLICAL LENDING (boom-controlled lending Recession- normal lending)	banks tend to maintain higher buffers during the period of boom, limit lending and thus 'cool down' the economy and stimulate the economy when it is in a downturn.
MORATORIUM PERIOD (EMI free months)	• The Moratorium Period is the time during the loan term in which the borrower is not required to repay the loan. • It is the relaxation time given to the borrowers before beginning with the loan repayment in the form of EMIs. RBI offered this in COVID-19 pandemic to various segments.
KIOSK BANKING (bank booth or van in your village)	• The Kiosk Banking is the initiative taken by the RBI for those living in villages or other remote areas who are deprived of banking services due to the non-availability of a bank branch in their locality. • In such arrangement, the person is not required to go the bank to avail the banking services, Instead the bank comes to the village where the person can make the transactions. • Kiosk are small booths with internet connections established in villages with personnel to help the customers avail basic bank services. They can be in a van as well.
Provisioning Coverage ratio (PCR). - (money to cover NPAs)	Under the RBI's provisioning norms, the banks are required to set aside a certain percentage of their profits in order to cover risk arising from NPAs.
MIBOR (Mumbai Inter-Bank Offer Rate) (loan by one bank to another bank)	• NSE developed and launched the NSE Mumbai Interbank Bid Rate (MIBID) and Mumbai Interbank Offer Rate (MIBOR) for the overnight money market. • The MIBID/MIBOR rate is used as benchmark rate for majority of the deals by the banks in transactions among them.
INTEREST SUBVENTION (part interest payment by Govt.)	• Government pays part of the interest rate for borrower. (farmer, MSME, affordable housing etc) such as: – Farm loans upto 3 lakhs → only 4% loan interest farmer has to pay. (remaining will be paid by Govt.) – MSME- 2% subvention.
CREDIT GUARANTEE (if borrower default, guarantor will repay loan)	• Credit guarantee means if the borrower defaults to pay interest or principle or both, then losses of banks/NBFCs will be covered by the credit guarantor. • If the government provides say a 100% credit guarantee up to an amount of Rs 1 crore to a firm, it means that a bank can lend Rs 1 crore to that firm; in case the firm fails to pay back, the government will make good all of Rs 1 crore. • Credit guarantee facilitates loans without requiring borrower to pledge collaterals

FUGITIVE ECONOMIC OFFENDER (ran after committing financial crime)	**A economic offender who has –** • Left the country to avoid facing prosecution. • Refuses to return to face prosecution. Against them an arrest warrant has been issued for committing any offence listed in the schedule of the act. **Ex.** Vijay malya, Neerav modi.
FUGITIVE ECONOMIC OFFENDERS ACT 2018 (100cr. Amount, confiscate property…... fakenotes, frauds, money laundering)	• The Fugitive Economic Offenders Act, 2018 seeks to confiscate properties of economic offenders who have left the country to avoid facing criminal prosecution. • Offences involving amounts of Rs. 100 crore or more fall under the purview of this law. • Some of the offences listed in the schedule of the bill are- counterfeiting government stamps or currency, cheque dishonour for insufficiency of funds, money laundering, transactions defrauding creditors etc
INDIAN BANK ASSOCIATION (IBA) (banks and financial institutions)	• It is an association of Indian banks and financial institutions formed in 1946. • It aims to promote and develop in India sound and progressive banking principles, practices and conventions and to contribute to the developments of creative banking.
BUSINESS CORRESPONDENT (Bank agent in rural area…. loan, deposit, recovery, pension, mutual fund, insurance… awareness, education)	• The RBI has allowed banks to appoint entities and individuals as agents for providing basic banking services in remote areas where they can't practically start a branch. • Business Correspondents are instrumental in facilitating financial inclusion in the remotest areas of country. **FUNCTIONS–** • Identification of borrowers, collection of small value deposit, disbursal of small value credit, recovery of principal, collection of interest, • sale of micro insurance, mutual fund products, pension products, other third party products and receipt and delivery of small value remittances, other payment instruments, • creating awareness about savings and other products, education and advice on managing money and debt counselling, etc.
INTEREST RATE SPREAD Interest rate for (loans- deposits)	• Spread refers to the difference in deposits/ borrowing rates and lending rates of financial institutions. • It is the interest yield such as interest on a loan minus interest rates paid on deposits/ borrowed funds.
PSBN NETWORK – ECO. SURVEY 2020 (one network having all information about borrowers from PSBs)	• Government should create a new organization named PSBN (PSB Network), which will act as a Financial Technology Hub and information depository. • Whenever a borrower applies for a loan to a public Sector Bank (PSB) then details will be sent to PSBN. • PSBN will verify the credit worthiness and risk profile of the applicant through Artificial Intelligence (AI), machine learning (ML) and Big Data Analytics • E-KYC-Aadhar Verification - cross checking his Aadhar number against Financial data from Ministry of Corporate Affairs, SEBI, Income Tax Department, GST, etc.

	• Advantages of PSBN – fraud prevention, reduced the burden of NPAs, quicker decision making, process loan applications faster, cost saving for individual banks as all of them can use a single hub instead of spending on separate servers/technology.

Non Banking finance companies.

Non Banking finance companies. **NBFC Types.** 1. Non Deposit accepting 2. Systemically Important NBFCs 3. Deposit accepting 4. Residuary NBFCs **Systemically Important NBFCs** NBFCs-SI- NBFCs whose asset size is of ₹ 500 cr or more are considered as systemically important NBFCs. **Example.** Power Finance Corporation Limited (PFCL), Rural Electrification Corporation Limited (RECL), IL&FS, etc. **NBFC-ND** - Non-Deposit taking NBFCs **Residuary**- other remained.	**CATEGORIES OF NBFCs** • **Asset Finance** Company – Principal business is financing physical assets such as automobiles, tractors, housing etc. • **Investment** Company –Principal business is acquisition of securities. • **Loan** Company –Principal business of providing loans • **Infrastructure Finance Company** –NBFC that deploys at least 75% of its total assets in infrastructure loans • **Infrastructure Debt Fund** –NBFC to facilitate the flow of long term debt into infrastructure projects • **NBFC-MFI** – Provides Microfinance
CONTEMPORARY PROBLEMS WITH NBFCs • **Multiple regulatory bodies –** RBI doesn't regulate all the NBFC. Other institutions such as NHB, SEBI, IRDAI, etc. are also involved depending on the type of NBFC. • Difficulties in access to credit • **Asset-liability mismatch –** in the operations of NBFCs as these firms borrow funds from the market for short term and lend it for long term. – It has led to a situation where the NBFCs are facing a severe liquidity crunch in the short term. • Mutual fund among the biggest fund providers to NBFCs via commercial papers and debentures. Now these investors are getting reluctant to lend post the IL&FS crisis. • **Riskier Lending Pattern** – NBFCs are less cautious while lending. For instance, NBFCs have grown their portfolio of small and micro loans in a big way where there are risks of lack of credit history, scale and historically high NPAs. • The unsecured loan segment is also on the rise in the NBFC segment.	**WAY FORWARD FOR NBFC SECTOR** • **Better Regulatory Regime** – The Financial Sector Legislative Reform Commission (FSLRC) recommendation of creating a body with powers to monitor risk-cutting across sectors should be implemented. • **Timely Project clearances** – Ensuring timely clearances, especially to infrastructural projects is a must to minimize cost inflation of these projects. • RBI must encourage NBFCs to securitise their assets that can be purchased by banks. • RBI may also open a special window for mutual funds to get refinance against collateral. **Points to remember-** • They look like a bank, but they are not bank. They are financial companies dealing in different matters. • NBFCs don't issue credit card. • They don't accept demand deposit.

• **Cascading effect of IL&FS default** – Default followed by downgrade of IL&FS recently has created a liquidity squeeze for the entire non-banking financial company (NBFC) sector. • **Delayed Projects** – Many infrastructure projects financed by NBFCs are stalled due to various reasons like delayed statutory approvals, problems of land acquisition, environmental clearance, etc. which has impacted their financial health.	

❖ SHADOW BANKING

- Shadow banking is a term used to describe bank-like activities (mainly lending) that take place outside the traditional banking sector.
- They are not fully regulated by the RBI.
- Examples of shadow lenders include Special Purpose Entities, Non Banking Financial Companies (NBFCs), Hedge Funds etc.
- These institutions function as intermediaries between the investors and the borrowers, providing credit, thus, leading to financial inclusion and hence generate liquidity in the system.
- However, the 2008 financial crisis has shown that shadow banking can be a source of systemic risk to the banking system. The risks can be transmitted directly and through the interconnectedness of these entities with the banking system.
- After the financial crisis, central banks including that of USA, Britain and the European Union (EU) have introduced many strong measures to control shadow banking.
- In India, the crisis of the NBFCs that was triggered by the liquidity problems of IL&FS in 2018, has brought back the attention to shadow banking sector.
- Shadow banking system’s assets are risky and illiquid. If there is a ‘bank run’ like situation, these shadow banks can’t honour the obligations as we saw in the ILFS crisis (2019)

➢ FINANCIAL SECTOR REGULATORY APPOINTMENT SEARCH COMMITTEE (FSRASC)

- As per the RBI Act, the central bank should have one governor and four deputy governors -Two from within the ranks and one commercial banker and another an economist to head the monetary policy department.
- This committee recommends on the posts to be filled due to any vacancy in this list.
- It is headed by Cabinet Secretary and includes additional Principal Secretary to the Prime Minister who is a permanent government nominee and 3 other experts.
- The same process is being followed in the selection of Chairman of SEBI and IRDAI.

Chapter - 5. NCERT

❖ Public goods

- Goods belonging to the public.
- National defense, roads, government administration etc. are referred to as public goods. Public goods may be produced by the government or the private sector

➢ features-

- non-excludable- available to all.
- 'free-riders'- no payment to use them.
- Non-rivalrous- use by all, yet available to all.
  Ex. Park, roads, temples.

(In economics, a good is said to be rivalrous if its consumption by one party reduces the ability of another party to consume it. Ex. Fruits, fishes.)

❖ Private goods –

Privately owned goods.
such as clothes, cars, food items etc.

GOVERNMENT BUDGET — MEANING AND ITS COMPONENTS

GOVERNMENT BUDGET	MEANING AND ITS COMPONENTS
GOVERNMENT BUDGET 112, annual financial statement, 1 feb.	• There is a constitutional requirement in India (Article 112) to present before the Parliament a statement of estimated receipts and expenditures of the government in respect of every financial year which runs from 1 April to 31 March. • This 'Annual Financial Statement' constitutes the main budget document of the government
Revenue budget. (current fin. year)	Income, expenditures that relate to the current financial year only are included in the revenue account (also called revenue budget)
Capital budget (asset, liabilities)	Those income, expenditures that concern the assets and liabilities of the government are accounted into the capital account (also called capital budget).
Objectives of Government Budget (Allocation, redistribution, stabilization)	**1. Allocation Function -** resource allocation to different sectors. **2. Redistribution Function -** The government sector affects the personal disposable income of households by making transfers and collecting taxes. It is through this that the government can change the distribution of income **3. Stabilization Function -** for full utilization of labor and other resources of the economy. **4.** The intervention of the government whether to expand demand or reduce it constitutes the stabilization function.

- Government Budget
  - Revenue Budget
    - Revenue Receipts
      - Tax Revenue
      - Non-tax Revenue
    - Revenue Expenditure
      - Plan Revenue Expenditure
      - Non-plan Revenue Expenditure
  - Capital Budget
    - Capital Receipts
    - Capital Expenditure
      - Plan Capital Expenditure
      - Non-plan Capital Expenditure

Plan and non-plan expenditure

	Revenue Expenditure	Capital expenditure
Plan (central plans)	plan revenue expenditure relates to central Plans (the Five - Year Plans) and central assistance for State and Union Territory plans. **Ex.** Govt schemes, programs.	Plan capital expenditure, relates to central plan and central assistance for state and union territories for asset creation. **Ex.** Schools, hospitals construction.
Non plan (salaries, pension, general, social, defence services)	• Non-plan expenditure, the more important component of revenue expenditure, covers a vast range of general, economic and social services. • The main items of non-plan expenditure are interest payments, defence services, subsidies, salaries and pensions. • Interest payments on market loans, external loans and from various reserve funds constitute the single largest component of non-plan revenue expenditure.	Non-plan capital expenditure covers various general, social and economic services provided by the government. **Ex.** Loans to state govt to cover their deficits.

- **Debate over this classification.**
  It has led to the misperception that non-plan expenditure is inherently wasteful, adversely affecting resource allocation to social sectors like education and health where salary comprises an important element.

❖ Surplus, deficit, balanced budget.

- The government may spend an amount equal to the revenue it collects. This is known as a **balanced budget**. (income = expenditure)
- When tax collection exceeds the required expenditure, the budget is said to be **surplus budget**. (income > expenditure)
- However, the most common feature is the situation when expenditure exceeds revenue. This is when the government runs a **budget deficit** (Income < Expenditure)

❖ Fulfilling budget deficit-Debate over Govt. Debt

➢ Internal debt - borrowing within the nation.

- Such 'debt does not matter because we owe it to ourselves'. This is because although there is a transfer of resources between generations, purchasing power remains within the nation.
- **Issue**- some private borrowers will get 'crowded out' of the financial markets as the government claims an increasing share of the economy's total savings.
- **Clarification**- However, one must note that the economy's flow of savings is not really fixed unless we assume that income cannot be augmented. If government deficits succeed in their goal of raising production, there will be more income and, therefore, more saving. In this case, both government and industry can borrow more.

➢ External debt

However, any debt that is owed to foreigners involves a burden since we have to send goods abroad, earn foreign currency corresponding to the interest payments to be made.

➢ Future generations and debt repayments.

- Issue- Current generation is benefiting from these debts but Future generations will have to repay them.
- Clarification- if the government invests in infrastructure, future generations may be better off, provided the return on such investments is greater than the rate of interest. The actual debt could be paid off by the growth in output.

❖ Fiscal Policy (Govt spending, Taxes, Subsidies, Investment)

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

- Using fiscal policy, the Govt influences the savings, investment and consumption in an economy, to accomplish certain national goals such as income redistribution, socio-economic welfare, economic development and inclusive growth.
- It is the sister strategy to monetary policy through which a central bank influences a nation's money supply.
- Fiscal policy is result of several component policies or mix of policy instruments. These include, policy on taxation, subsidy, welfare expenditure, etc; investment or disinvestment strategies; and debt or surplus management.

Aims -

1) Full Employment 2) Economic Growth 3) Price stability

Fiscal policy is based on the theories of British economist John Maynard Keynes (Keynesian economics). This theory basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending.

1. **Types of fiscal policy**
   a. Neutral Fiscal Policy
   b. Contractionary Fiscal policy
   c. Expansionary Fiscal Policy

a	**Neutral Fiscal Policy** (Govt. spending=tax revenue) no effect on economy	Policy implies a balanced budget where Govt. spending is equal to the Tax revenue. It further means that government spending is fully funded by tax revenue and over all the budget outcome has a neutral effect on the level of economic activity

b	**Contractionary (restrictive) Fiscal policy** (Cutting demand, govt spending and inflation, increasing taxes)	Policy involves raising taxes or cutting govt spending, so that Govt spending is less than Tax revenue. It cuts up on the aggregate demand and to reduce the inflationary pressures in the economy
c	**Expansionary Fiscal Policy** (Tax cuts, increased govt spending. used in recession.)	Policy is generally used for giving stimulus to the economy. i.e. to speed up the rate of GDP growth or during a recession when growth in national income is not sufficient enough to maintain the present standards of living. A tax cut and/or an increase in government spending would be implemented to stimulate economic growth and lower unemployment rates. This is not a sustainable policy, as it leads to budget deficits and thus, should be used with caution.

❖ Fiscal Consolidation (reduce expenditures, losses)

Fiscal Consolidation involves reduction in government expenditure to control its Fiscal Deficit, debts and improve financial performance Rather than eliminating fiscal debt and deficit, it aims to control it Such as:

- Reducing the leakages of subsidies and funds by targeted delivery of schemes and subsidies through Direct Benefit Transfer (DBT) through Jan-Dhan Aadhar Mobile (JAM) trinity.
- Reducing the quantum of subsidies: e.g. Deregulation of Petrol prices (2010) and later Diesel (2013)
  1. **2016 :** Oil Ministry began to block LPG-Pahal subsidies to persons with annual taxable income of ₹ 10 lakh and above.
  2. **2017 :** Oil Ministry asked oil companies to keep raising prices of subsidized kerosene by 25 paise every fortnight until the subsidy is eliminated.
- Shutting down loss making PSU. E.g. Hindustan Photo Films, HMT Bearings, HMT Chinar Watches, Tungbhadra Steel, Hindustan Cable & HMT Watches (2014).
- Privatization of loss making PSU and PSBs. e.g. selling off of Air India
- **2014-16 :** Government set up an Expenditure Management Commission under Bimal Jalan to suggest ways to reduce its Expenditure. Austerity measures e.g.
- **2018 :** Bengal govt issued directives to its departments banning flower bouquets and mementoes in public functions, banning officials meetings at private hotels, frequent installation of AC, car purchases, office renovations etc. & restricting the number of foreign tours by Ministers / IAS etc., More use of video-conferencing instead of physical travel.
- **2019 :** PM's Cabinet Committee on Investment and Growth (CCIG) ordered all Union ministries to reduce wasteful expenditure on travel, food and conferences by 20%.

❖ Fiscal Discipline (balanced finances)

- Fiscal Discipline refers to a state of an ideal balance between revenues and expenditure of government, in an economy.
  - Zero revenue deficit
  - Low fiscal deficit
  - Borrowings used in Investment
  - Right balance of direct and indirect taxes.
- If the fiscal discipline is not maintained, then the government expenditure exceeds government receipts. Under this condition, the government would have to borrow funds or incurred deficit financing from the central bank. This may depreciate the currency and create inflation in an economy.

❖ Fiscal drag (high income but no extra spending as high taxes)

- Increased income of people does not convert into savings or investment or spending due to high taxes.
- Rising income → Rising inflation and increased taxes → reduced savings/investment → slow economic growth.
- Fiscal drag basically means a slowdown of economic growth due to lack of spending as increased taxation reduces demand for goods and services.
- The resulting lack of aggregate demand leads to deflationary pressure, or drag, in the economy, essentially due to lack of state spending or to excessive taxation.
- One cause of fiscal drag is bracket creep, where progressive taxation increases automatically as taxpayers move into higher tax brackets due to inflation. This leads to moderation of inflation, and can be characterized as an automatic stabilizer of the economy. Fiscal drag can also be a result of a hawkish stance towards govt. finances.

❖ Fiscal Slippage (Inability to meet fiscal targets.)

- Inability to meet fiscal targets.
- For instance, if government has targeted to keep the fiscal deficit within 3.3% percent of GDP, but if it crosses that limit, it is called as fiscal slippage.
- Excess expenditures, Revenue shortfall

Causes- economic slowdown, petroleum oil shock, disaster, war or any other cause

❖ Opportunity cost (what you are giving up)

- Opportunity cost refers to a benefit that a person could have received, but gave up, to take another course of action. Stated differently, an opportunity cost represents an alternative given up when a decision is made. Opportunity cost is also called the economic cost.
- Opportunity Cost = Returns from Most Lucrative Option – Returns from Chosen Option. (ex. Govt spend money on road rather than school)
- As per microeconomics, opportunity cost is zero for free goods such as Air and common goods such as fish / grazing land.
- For public goods such as street lights and defence, opportunity cost is involved (Government could have spent that much money on street lights rather than on military). Opportunity cost is not zero in case of public goods.

Q. If a commodity is provided free to the public by the government, then:

a) The opportunity cost is zero.
b) The opportunity cost is ignored.
c) The opportunity cost is transferred from the consumers of the product to the taxpaying public.
d) The opportunity cost is transferred from the consumers of the product to the government.

❖ Chief Economic Advisor

- Falls under Department of Economic affairs, Ministry of Finance.
- Usual tenure 3 years, reappointment possible, but not a constitutional or statutory body.
- CEA has control over Indian Economic Service (IES)
- Notable CEAs in Past:
  - Manmohan Singh,
  - Raghuram Rajan,
  - Arvind Subramanian
  - K. Subramanian.

- V. Nageshwaram

➢ Loan repayment terminology.

Redemption Regular payment	Repay the loan principal and interest at regular interval. Also known as Terminal Annuity
Sinking Fund Repayment fund	Govt. creates a special fund and keeps depositing money in it regularly. So at the time of G-sec maturity, it has enough 'buffer' money to honor the loan repayment. First introduced in England
Repudiation Refusal	Govt. does not recognize its obligation to repay the loan. E.g. After Russian Revolution (1917) Lenin's Govt. refused to pay the loans taken by the previous Czar regime from Britain & France.

➢ TERMINOLOGIES

Ricardian equivalence	General belief: high Govt spending will increase demand in the economy however it doesn't happen. The Ricardian Equivalence is an economic proposition that holds that when there is increased debt-financed spending by the government in order to stimulate the economy, demands remain unchanged. In the face of high deficits, people save more
Discretionary fiscal policy	This deliberate action to stabilize the economy by Govt. Ex. When private investment falls, Govt. spending is increased to maintain stability.
Crowding out effect	When governments borrow, they compete with everybody else in the economy who wants to borrow the limited amount of savings available. As a result of this competition, the real interest rate increases and private investment decreases. This phenomenon is called crowding out.

❖ TAXATION

Proportional taxes - in proportion to income.
The proportional income tax, thus, acts as an automatic stabilizer – a shock absorber because it makes disposable income, and thus consumer spending, less sensitive to fluctuations in GDP.

➢ Equalisation Levy / Google Tax

- Equalization Levy (Direct Tax) was introduced in India in 2016, with the intention of taxing digital transactions. the income accruing to foreign e-commerce companies from India.
- It is aimed at taxing business to business transactions.
- If a foreign company makes profit in India, they have to pay 40% Corporation Tax.
- If an Indian businessman purchases digital advertisement slots in google-ad sense or facebook then those (foreign) e-ad companies are making profit. But earlier, they did not pay tax on that profit, claiming their business activity (of displaying digital-ads) is done outside India on global servers.
- Budget-2016 imposed 6% tax on such income of foreign technology companies.
- Officially called "Equalisation Levy", not part of "Income Tax" or "Corporation Tax" under the Income Tax Act 1961, but a separate levy altogether imposed by the Finance Bill 2016.
- Foreign Company cannot escape it saying we are protected under the Double Taxation Avoidance Agreement (DTAA) in our home country.

Significant Economic Presence (SEP) : Concepts basically means if a foreign company is making money from Indians through digital ads / streaming services (e.g. NETFLIX videos from overseas servers) then the company has 'SEP' in India, therefore, Indian govt has powers to tax it.

Q. With reference to India's decision to levy an equalization tax of 6% on online advertisement services offered by non-resident entities, which of the following statements is/are correct? (CSE-2018)

1. It is introduced as a part of the Income Tax Act.
2. Non-resident entities that offer advertisement services in India can claim a tax credit in their home country under the "Double Taxation Avoidance Agreements".

a) 1 only b) 2 only c) Both 1 and 2 d) Neither 1 nor 2

Minimum Alternate Tax (MAT)

- Some industrial houses use tax-deduction-exemptions-depreciations and accounting tricks to become "Zero Profit Companies" & escape paying Corporation Tax.
- Budget-1996 introduced 5% MAT on book profit using a different type of formula.
- Book profit- the profit earned by a corporation.
- Net profit- profits after subtracting expenditures.

Direct Tax Code (DTC) Task Force (2017-2019)

Direct Tax Code- A code to simplify direct taxes like income tax, corporate tax. (Like GST simplified indirect taxes.)

- Finance Ministry in 2017, setup DTC taskforce under CBDT member Arbind Modi.
- While Govt is yet to release this report in public domain, but according to journalists, it contains following suggestions:

1. Replace the Income Tax Act 1961 with a simpler Direct Tax Code.
2. Reduce the corporation tax further.
3. Tax rates for domestic and foreign companies should be same. This will encourage ease of doing business in India.
4. Give additional tax relief for the start up companies.
5. Increase the number of tax slabs from present three (5%, 20%, 30%) to four (10%, 20%, 30% and 35% for super-rich earning INR 2 crore and above).
6. Abolish Dividend Distribution Tax (DDT). [done in Budget-2020]
   Setup Litigation Management Unit (LMU) to look after the tax related court cases in an efficient manner.

Tobin Tax (Robinhood Tax)

- Nobel recipient American economist James Tobin proposed (1970s) a small tax every time currency is converted into another currency (e.g. from Dollar to Rupee and vice versa).
- Such tax will discourage short term speculative investment and flight of capital from one country to another.
- Tobin tax helps stabilizing the global economy and currency exchange rates.
- In India, foreign currency conversions are subjected to (previously Service Tax) & now GST
- Robinhood Tax- **a suggested set of taxes on banks and financial transactions** (the buying and selling of shares, bonds, etc.) that would provide money to protect public services and the environment, help the poor, etc. ex. Tobin tax.

➢ Pigouvian TAX

- Pigouvian tax is the one used/imposed in order to diminish the negative fallouts of externalities. For instance, it is generally imposed on high polluting industries which not only causes harm to environment but poses health risks to the people living nearby.
- An externality is a positive or negative consequence of an economic activity experienced by unrelated third parties. E.g. Cement company, whereas unrelated third parties (local community, flora and fauna) are harmed by cement company's air-pollution.
- English economist Arthur C. Pigou proposed taxing the companies that create such negative externalities. E.g. polluting industries, cigarettes (passive smoking), alcohol (social disharmony).
- India has high level of indirect taxes on petroleum, tobacco and alcoholic products.
- Prior to GST, we had "Clean environment cess" on Rs 400 per tonne of coal.

❖ Sin Tax/Consumption Control–

- A sin tax is imposed on goods and services, which are perceived as harmful to society. Examples of products on which sin tax is imposed are: tobacco, gambling ventures, alcohol, cigarettes, etc
- It can be used as a tool to discourage consumption of undesirable goods.
- India also imposes a higher tax on Alcohol, cigarettes, sugary carbonated beverages etc.

➢ Prevention Of Money Laundering Act (PMLA-2002)

- In 2002, India enacted this law to combat money laundering with search-seizure-arrest-penalty. Nodal agency is the Enforcement Directorate.
- Cases are heard at PMLA Adjudicating Authority à PMLA Appellate Tribunal à High Court
- It also empowers the RBI, SEBI, IRDAI and other regulators to make norms for Banks/NBFCs & punish the errant parties. Eg. RBI's Know Your Customer (KYC) norms and Anti-Money Laundering (AML) standards.

➢ Benami Transactions Prohibition Act (BTPA-1988/2016)

- Benami refers to properties that a buyer registers in the name of his relative, personal staff (Driver, Gardner) or a non – existent / fictitious persons to avoid tax authorities' attention.
- Original act of 1988 failed to deliver robust results. So govt. amended in BPTA in 2016.
- Nodal Agency – Income Tax Department.
- Cases are heard at PMLA Adjudicating Authority à PMLA Appellate Tribunal which is concerned High Court
- Violation invites Confiscation of property + penalty + upto 10 years jail time.

➢ Double Taxation Avoidance Agreement (DTAA) & Round Tripping

- It is a tax treaty signed between two or more countries.
- **Objective** – A taxpayer resides in one country and earns income in another, then he need not pay (direct) tax twice in two countries for the same income.
- **Eg. India Mauritius DTAA (1982):** If a Mauritius person / company buy shares in India and sells them at profit, then he need not pay Capital Gains Tax (CGT) in India. Only the Mauritius government can ask CGT from him. And vice-versa.
- **Loophole** – India has around 10-20% CGT whereas Mauritius has around 0-3% CGT (depending on nature of asset, how long the buyer kept asset before selling etc). So many Indian Politicians, Businessmen and Bollywood actors would transfer the money using Hawala to their shell companies in Mauritius, and then make those Mauritius shell companies to invest back in Indian assets & avoid paying Indian CGT. This process is called **Round Tripping**. Money that leaves the country through various channels and makes its way back into the country as foreign investment. Now no tax on profits made.

- Similar loophole in India Singapore DTAA.
- In 2016, the government amended the treaties, even Mauritius and Singapore investments in India will be subjected to Indian taxes.

➢ Base Erosion & Profit Shifting (BEPS) (shifting profits to tax heavens)

- When MNCs shift profit from its source country to a tax-haven to avoid / reduce paying taxes, it's known as "BEPS". Ex. flipkart is domicile/registered in Sinapore.
- 2019-July: India ratified the OECD's joint Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.
- Multinational Company (MNC) "A" opens fast food outlets in India & makes ₹ 50 crores profit. By default, it should be subjected to 40% Corporation tax in India.
- But then MNC shows its Indian outlets had taken loan / raw material / patented technology from MNC's shell firm in Singapore (where Corporation tax is 0-2%). So, after deducting these operating costs, it has zero profit, so in India, it will pay only 18.5% Minimum Alternative Tax (MAT), instead of 40% Corporation tax.

➢ Transfer Pricing (trade in related entities. Ex. subsidiaries/parent company)

- Transfer pricing happens whenever two subsidiary companies that are part of the same multinational group, trade with each other.
- prices are set for goods and services sold between these related entities (may be situated in different countries) within an enterprise.
- Suppose Coca Cola's (Indian Subsidiary company) sells shares to Coca Cola's (UK subsidiary company) at ₹ 10 rupees. Then ₹ 10 is the transfer price.
- Coca Cola (UK) further sells shares / to other companies at very high price. Yet, Indian tax authorities will not get any Capital Gains Tax (CGT) even though parent Coca-Cola (USA holding company) may be making profit (Capital Gains) of billion$ from this 'Indian Asset'

Advance Pricing Authority - an agreement between a taxpayer and tax authority determining the transfer pricing methodology, for pricing the taxpayer's international transactions for future years.

➢ General Anti Avoidance Rule (GAAR)

(notice to companies for suspected tax avoidance under DTAA,BEPS, transfer pricing etc.)

- Indians and foreigners avoid tax payment in India through loopholes like DTAA, POEM, BEPS, Transfer Pricing etc.
- So, UPA Govt setup economist Parthasarathi Shome panel who suggested General Anti Avoidance Rules (GAAR), they were incorporated in Income Tax Act in 2012.
- GAAR empowers Income Tax officials to send notices to both Indians and foreigners for suspected Tax Avoidance. If they feel any company has misused these provisions just to avoid taxes. Ex. vodafone was issued notice after Hutch deal.
- For Tax evasion, we have separate laws- PMLA, UFIA, BTPA.
- However, critics alleged GAAR will result in tax terrorism, harassment, no ease of doing business. So successive Budgets kept delaying the GAAR- implementation. Finally done on 1/4/2017.

➢ Tax Information Exchange Agreement (TIEA) (India signs with other nations)

- India has signed such agreements with multiple countries. It enables mutual sharing of information to detect tax avoidance and tax evasion.

- Ex. 2019: India has notified a tax information exchange agreement (TIEA) with the Marshall Islands (whose Capital is Majuro; it's the first country in the world to launch sovereign cryptocurrency named, Sovereign Coin.)
- Nodal agency On Indian side, CBDT (central board of direct taxes) is the Nodal agency for such agreements.

USA's Foreign Account Tax Compliance Act (FATCA-2010) (report on american investors)

- US Government signs inter-governmental agreement (IGA) with the other countries, to get information about American investors.
- USA's FATCA Act requires foreign financial Institutions (such as Indian Banks, UK Insurance Companies, Chinese Mutual Funds etc) to report the assets held by Americans.
- 2014, April: India and USA signed an FATCA-IGA agreement.
- This helps US Tax authorities to detect tax avoidance / evasion by Americans who are hiding income outside USA

TERMINOLOGIES

Tax buoyancy **(**tax collection growth rate/ GDP growth rate**)**	• Tax buoyancy highlights the relationship between the change in the government's tax revenue growth and the changes in GDP. • If GDP grew by x%, then how much % tax collection will grow? • Tax buoyancy = tax collection growth rate/ GDP growth rate • E.g. if GDP growth rate is 10%, income tax collection growth rate is 11% then Income Tax's tax buoyancy is 1.1 • When a tax is buoyant, it shows an increase in its revenue rate with increase in GDP growth rate. (without increasing the tax rate.) • Tax buoyancy is influenced by the size of the tax base, ease of the tax administration, reasonableness and simplicity of the tax rates etc.
Tax elasticity (changes in tax revenue/changes in tax rate)	• Tax elasticity is the responsiveness of tax revenue to changes in tax rate. • For example, how tax revenue changes if the government reduces corporate income tax from 30 per cent to 25 per cent indicates tax elasticity. • Or if the Govt increases excise duty by 20%, what will be change in excise revenue collection.
Negative income tax (cash to poors)	• It is an arrangement where cash is given by the government to certain tax residents who are earning below a specific threshold. • Subsidies are examples of negative income tax. • This arrangement was initially proposed by Nobel laureate Milton Freidman as a way to address inequality prevailing in society.
Tax-to-GDP ratio (Tax revenue/GDP) * 100	• It is a representation of the size of the government's tax revenue expressed as a percentage of the GDP. • Higher the tax to GDP ratio the better financial position the country will be in but a very high ratio shows high tax pressure on the economy which is not good. • Usual value- ~7%.

Central Board of Direct Taxes (CBDT) statutory.	• It is a statutory authority that functions under the Central Board of Revenue Act, 1963. • It is a part of the Department of Revenue in the Ministry of Finance. • It provides inputs for policy and planning of direct taxes in India and is also responsible for the administration of direct tax laws through the Income Tax Department.
Tax Haven	• It is a country that demands little taxes from foreigners and offers legal loopholes for Tax Avoidance & opportunities for Tax Evasion. E.g. Mauritius, Marshall Islands, Cayman Islands, Panama etc. These countries are geographically small, & without viable economy. So they offer such mechanism to attract foreign investors and foreign tourists.
Hawala (illegal money transfers)	• Hawala is an illegal money transfer or remittance system. Money is paid to an agent who instructs an associate in the relevant country or area to pay the final recipient. • Although used by Indian workers in middle east because lower commission than post-office/bank transfers. Hawalas have better network in remote areas.
Shell firms, Post-box/ Letter-box companies (no active business)	• They do not have any active business operations. Created with sole objective of money laundering/tax evasion/avoidance
Tax Terrorism (Harassment by tax officers)	• When tax authorities put undue pressure on an honest taxpayer to pay more taxes. • In 2012, Vodafone won a case against income tax department in the supreme court related to Capital Gains Tax on purchase of Hutch mobile company. • Afterwards, UPA government amended the Income Tax Act with retrospective effect and issued fresh notices against Vodafone.
Financial Action Task Force (FATF-1989) (G7, money laundering, gray /blacklist)	• FATF is a brainchild of G7, Combating Money laundering and terror finance. HQ – Paris. India became member in 2010.
	• Gray list à Nations that safe haven for terror financing and money laundering. E.g. Pakistan, as of Jan-2020.
	• Blacklist à Nations that are not cooperating in the global fight against money laundering, terrorist financing. Iran and N. Korea