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—Sanjay Kumar, IPS

Indian Economy

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Preface

For students who are studying in college, university or are preparing for varied competitions, including prestigious exams like civil services, a good grasp and understanding of Indian economy is paramount and more generally for appreciating how Indian economy works. I have seen many civil services aspirants struggling to get familiar with the vast and complex issues of 'Indian Economy'. Similar is the fate of university and college students. Though there are good books available in the market, most of them are factual in nature that bombard the reader with a plethora of data or expound the various economic issues in a very intricate manner. For a general reader who wants to acquaint with wide-ranging dimensions of Indian economy, it remains a distant dream. No doubt there are wonderful research papers and reports but reading them all is something extremely difficult and they also remain outside the ambit of students because of lack of time or awareness. The present book is a humble attempt to address such problems.

The present work is the culmination of my teaching and understanding of Indian economy for the past 13 years. The book is divided into seven sections and comprises thirty chapters that cover almost every aspect of Indian economy. The book covers the syllabus of civil services optional and general studies, graduate and post-graduate courses of Indian universities, Indian economic services, UGC and other competitive exams. An attempt has been made to first discuss the concepts and then analytically explain the trends and direction of Indian economy. The chapter summary at the end of every chapter provides the crux of the whole chapter and will be a significant help to revise the chapter in a short span of time especially before the exams. The multiple-choice questions at the end of every chapter will broaden the objective understanding of the reader. Glossary at the end of book will help the students to understand the various complex terms associated with Indian economy.

I am thankful to team 'Pearson' who painstakingly worked day and night for the accomplishment of this project. Special thanks to Anindita Malhotra, Editor—Higher Education, G. Sharmilee, Senior Editor—Productions and Kaushal Kumar Jajware, Editor—Acquisitions for their efficiency and cheerful disposition. I want to extend my gratitude to my parents and brother Munish who had been an inspiring force behind this monumental work. I am indebted to my wife Dr Babita for her consistent support during the writing of the book. I am thankful to my little son and best friend 'Ninaad' who gives me meaning to work hard and smile, and despite my best efforts to play and enjoy with him, understood me, whenever I was busy in this project. I feel blessed for the light shown by my 'Gurus' and 'almighty', and bow my head in deep reverence and gratitude.

I will welcome and appreciate suggestions from teachers and students for further improvement of the book.

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1 Few Basic Concepts and Nature of Indian Economy

The first lesson of economics is scarcity: there is never enough of anything to fully satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.

—Thomas Sowell

Introduction

For those who are born and living in India, the economy is providing abundant goods and services to choose from. People get jobs, start new business venture, travel and communicate with anybody anywhere within the India and outside, and yet many of us have no idea how it all works. From the agriculture production by a farmer in some remote Indian village to the sale and purchase of derivatives in Bombay stock exchange, economics has countless dimensions and a serious seeker of the subject needs to be fully informed about the nuances of Indian economy. One of the main tasks in this very book is to make us understand how Indian economy works, how well it works, and what can be done when it does not work well.

This chapter addresses the following key issues:

- Economics and Economic problems
- Microeconomics and Macroeconomics
- Capitalism, Socialism, and Mixed economy
- Input and Output
- Nature of Indian Economy

What Is Economics?

We all know that human wants are unlimited but resources are limited. This is also called "basic economic problem." Wants generate demand and resources generate supply. Consider a world without scarcity. If infinite quantities of all goods and services were easily produced and all demands were easily met, would there be any economic problem? Businesses would not worry about cost of labor or availability of raw material; the governments would not worry about taxes and subsidies and other economic policies; consumers would not worry about prices and availability issues. It is because there would not have been any demand and supply problem.

For example, we all need oxygen to survive. But do we pay for that? Absolutely no! It is because there is abundant oxygen available in the atmosphere for all of us. But if you want to scale Mount Everest or if you are an astronaut, you will surely carry oxygen cylinder along and it will cost you as well. Therefore, "Economics is the study of how societies use scarce resources

to produce valuable commodities and distribute them among different people."[1] Economics thus addresses the basic economic problem of rational management of resources or the problem of optimum utilization of resources. This economic problem poses three important questions to policymakers and economists of all the nations worldwide. These questions are (1) what to produce? (2) how to produce? and (3) for whom to produce?

Let us look more closely to these questions:

1. *What to produce*?
   Immediately after independence, India confronted with the problem of food grain shortage and started importing wheat from the United States under 1954 food aid program[2] (PL 480).* But after the war with Pakistan during 1965, the changing geopolitics led to the scrapping of food aid by the United States and India faced the urgent need of going for some out of box measures to increase agriculture production. New agriculture strategy (green revolution) in the form of HYV seed technology was adopted in 1966 in the three states of Punjab, Haryana, and western Uttar Pradesh. To address the problem of "what to produce," green revolution was a clear-cut choice of the policymakers of that time.
2. *How to produce*?
   In any economy, the government or policymakers determine who will do the production and with what techniques? Whether the country should go for labor-intensive techniques or capital-intensive techniques? Obviously, a capital-rich nation (or labor scarce nation) should go for capital-intensive techniques and a labor surplus nation (or capital deficit) country should go for labor-intensive techniques. For example, Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) was launched in India in the year 2006 to produce rural assets by labor-intensive techniques. India being a labor surplus country requires labor absorbing techniques, and for that, the government has envisaged 60:40 wage-material ratio under MNREGA at district level.
3. *For whom to produce*?
   The government needs to take a decision regarding who will be the beneficiaries of production activities. How will be national income divided between different residents of the country? For example, bank nationalization of 1969 was announced by the government so as to make the institutional credit available to common man. Before 1969, Indian banking was class banking, as it addressed credit needs of few rich private sector corporates. Bank nationalization was a move to transform Indian banking from class banking to mass banking. If poverty is high, the government may think of effective public distribution system. Pradhan Mantri Ujjwala Yojana (providing LPG connections to women of BPL families) and Deendayal Upadhyaya Gram Jyoti Yojana (for rural electrification) are few other examples.

The Two Branches of Economics: Microeconomics and Macroeconomics

The effective birth of economics as a separate discipline may be traced to the year 1776, when the Scottish philosopher Adam Smith published "An Enquiry into the Nature and Causes of the Wealth of Nations."[3] There are two major branches of economics: Microeconomics and

* The P.L. 480 agreements aimed at supply of surplus agricultural commodities from the United States against payment of the rupee equivalent of the dollar cost of these commodities plus 50% of the ocean freight cost.

BOX 1.1 Water-diamond Paradox

The classical economist, *Adam Smith*, the father of economics, in his famous book *An Enquiry into the Nature and Causes of Wealth of Nations* has tried to explain the problem of scarcity with the help of famous *water-diamond paradox*. According to him, water is very essential for life but has very little or no value. But diamond is not essential and is very costly. The price is not determined by total utility or total satisfaction gained from a product but depends upon the satisfaction derived from each additional unit of the commodity, which is called marginal utility. Since water is available in abundance, its marginal utility is less. It is because each additional unit of water that becomes available can be applied to less urgent uses as more urgent uses for water are satisfied. Therefore, with increase in the supply of water, each additional unit of water becomes worth less to people. On the other hand, diamonds are in such low supply that the usefulness of one additional diamond is greater than the usefulness of one additional glass of water, which is in abundant supply. Hence, diamonds are most costly than water.

Source: Smith, A. (2007). *An enquiry into the nature and causes of wealth of nations*. Metalibri, p.26.

macroeconomics. Microeconomics studies the behavior of individual entities, households, firms, and markets. Adam Smith is considered as the founder of the field of microeconomics. Macroeconomics on the other hand studies the overall performance of the economy. Macroeconomics in its modern form can be attributed to John Maynard Keynes who published his revolutionary "General Theory of Employment, Interest, and Money" in the year 1936. Macroeconomics examines a wide variety of areas, such as how total investment and consumption are determined, how central bank manages money and interest rates, what causes international financial crisis, and why nations grow rapidly while others stagnate.[4]

Capitalism, Socialism, and Mixed Economies

The questions of what, how, and for whom are answered by different economic systems differently. Capitalism also called as market economy is an economic system in which private firms and individuals make the major decisions regarding production and consumption. There is little government intervention or central planning, and price- and output-related decisions are taken by demand and supply forces (price mechanism). On the other hand, socialism is a school of thought in which means of production are owned by the government. All production and distribution decisions are taken by the government, and individuals rely on the state for everything from food to healthcare. It is the government that determines output and pricing levels of these goods and services. Socialist economies are also called command economies. North Korea, Cuba, and former Soviet Republic can be placed in the category of socialism. A mixed economic system is a system that combines the aspects of both capitalism and socialism. A mixed economic system protects private property and allows a level of economic freedom in the use of capital, but also allows for the governments to interfere in economic activities in order to achieve social aims. In fact, all economies of the world are mixed economies, though economies may tilt toward capitalism and socialism. There has never been a 100% capitalist economy (although 19th century England came close). There has never been a 100% socialist economy either as market forces always work in some form or other. However, Indian economy since independence is

envisaged as a mixed economy by the planners and started its march toward capitalism since 1991 economic reforms.

Inputs and Outputs

To answer the question of what, how, and for whom, every country needs to make a choice regarding inputs and outputs. Inputs are the goods and services that can be used to produce goods and services. For example, bricks, sand, cement, labor, glass, and wood are inputs required to manufacture building. Outputs are various useful goods or services that are produced with the help of inputs in the production process and can be consumed or employed in further production. For example, biscuits are the output that can be consumed by consumer and photo state machine (which is also the output) can be used for copying the documents. Another term for inputs is factor of production. Factors of production can be broadly classified into four broad categories: Land, labor, capital, and entrepreneurship. The payment made for the use of factors of production is called factor cost or factor income.

1. Land—also called as natural resource—represents the gift of nature and consists of land used for agriculture, constructing factories or roads, some useful raw materials like iron ore and copper, and energy resources like hydroelectricity and petrol. The payment made for the use of land or land resources is called rent.
2. Labor represents human time spent in the production, for example, teaching in schools, ploughing the land, and working in industries. Labor gets wages as factor income. Wages are high in labor deficit countries (in Canada, Australia, the United States, and European Union) and low in labor surplus nations (China, India, Bangladesh, etc.).
3. Capital signifies the machines or durable goods which are produced to produce further goods and services. For example, washing machine, photo state machine, roads, automobiles, and buildings. Capital is also called financial wealth or investment which is used to start and maintain business. Interest is paid for the use of capital. In the developed countries which are capital rich, the interest is low. In the developing countries like India which are capital scarce, the interest rate is comparatively high.
4. Entrepreneurship signifies the capability of an entrepreneur to visualize operations of business and take risks. Entrepreneur combines the other factors of production, viz., land, labor, and capital, to produce goods and services. For his services, entrepreneur gets profit.

Economic Growth and Development

Traditionally, economic development has been considered as synonymous with economic growth. Modern view, however, tries to differentiate between growth and development. Let us have a look.

- Economic growth means a sustained increase in country's output and measured in terms of gross domestic product or growth per capita. Economic development on the other hand measures the technological and institutional change by which increase in output takes place.

- Economic growth is a narrow concept as it measures the quantitative change in the economy in terms of increase in output. Economic development on the other hand is a broader concept and measures change in composition and distribution of national and per capital income. Economic development is determined by the improvement in life expectancy rate, infant mortality rate, literacy rate, and poverty rates. Economic development, thus, measures both the quantitative and qualitative aspects of change in national income.
- Economic growth is a short period process and is measured annually. Economic development on the other hand is a long-term process and takes place over the period of time.
- Economic growth is a continuous process and is measured in terms of sustained indicators like Gross Domestic Product (GDP). Economic development is a discontinuous process involving periods of expansion and of recession, reflecting the existence of business cycles[5].
- Economic growth as a concept is related with the developed countries. For the developed economies, development is not the problematic issue as such economies have already attained the qualitative targets and reached the pinnacle of institutional and technological progress over the period of time. For such countries, the major challenge is to attain a minimal required level of GDP growth so that economy does not plunge into recession. However, the major challenge for the developing countries like India is to undergo technological and institutional change so as to attain quantitative and qualitative progress.

BOX 1.2 Few Prominent Schools of Economics

Mercantilism: Mercantilism is a school of thought which dominated European thought between the 16th and 18th centuries. Mercantilists believed that precious metals, such as gold and silver, were crucial to nation's wealth and prosperity. If a nation did not possess mines or have access to them, precious metals should be obtained by trade. The major pioneers of mercantilism were Thomas Mun in England, Jean-Baptiste Colbert in France, and Antonio Serra in Italy.

Physiocrats: This school of thought was founded in the 18th century France by François Quesnay. The school believes that the government policy should not interfere with the operation of natural economic laws and that land (agriculture) is the source of all wealth. Physiocrat is regarded as the first scientific school of economics.

Classical economics: Classical economics is a school of economic thought that originated during the late 18th century Britain with Adam Smith and that reached maturity in the works of David Ricardo and John Stuart Mill. The theories and models of classical school emphasized economic growth and economic freedom, stressed laissez-faire ideas, and free competition. Classical economics introduced labor theory of value, assumed full employment situation under market economy, and hailed trade as an engine of growth.

Marxian economics: Marxian school of economics thought was mainly developed by Karl Marx, and to a lesser extent, by Friedrich Engels in the mid-19th century. The Marxian economics analyzes the process of economic evolution through crisis in capitalism and its doom. It studies the distribution of the surplus product and surplus value in various types of economic systems, the nature and origin of economic value and analyzes the impact of class and class struggle on economic and political processes.

Keynesian economics: Keynesian economics represents the body of ideas set forth by John Maynard Keynes in his popular book "General Theory of Employment, Interest and Money" published in 1936 and remained the dominant school of macroeconomics and guided the economic policy framework of most Western governments until the 1970s. Keynesian economics is a short-run demand side theory which believed that "full employment" is an exception and economic disequilibrium (because of the change in aggregate demand) can be corrected by suitable policy response and government intervention.

Chicago School of Economics: Chicago school of economics was developed by Department of Economics at the University of Chicago and emphasizes free-market principles. It was founded in the 1930s, mainly by Frank Knight, and subsequently, developed by Gary S. Becker, Ronald Coase, Milton Friedman, Merton Miller, and George Stigler. At the heart of the Chicago school's approach is the belief in laissez-faire as it rejected Keynesianism in favor of monetarism. Until the mid-1970s, it turned to new classical macroeconomics profoundly based on the concept of rational expectations.

Sources:

1. Landreth, H., Colander, D.C. *History of economic thought*, 4th ed. Houghton Mifflin Company.
2. Backhaus, J.G. (2012). *Handbook of the history of economic thought*. Springer.

Types of Economies

International economic institutions and economists classify countries around the world based on their level of economic and industrial development. Let us have a look at this.

Developed economies: A developed economy is one which has high per capita income, developed financial markets, and high level of human development. Such nations are characterized by higher level of productivity in agriculture, industry, and services. The United States, Canada, Japan, and countries of European Union can be placed under this category.

Emerging economies: The term "emerging markets" dates back to 1981 and was invented by Antoine van Agtmael. The emerging market has many things in common with the developed countries but lack in certain standards to be termed as developed economies. For example, China, India, Brazil, Russia, and South Korea are termed as leading emerging markets in the world.[6]

Developing economies: Developing countries have low levels of living and productivity, high population growth, underdeveloped industry, and reliance on agriculture and exports for economic sustainability. The difference between the developing nations and the emerging nations is that the latter are growing rapidly and becoming more important in world economics, while the developing nations are struggling and still need help from trade partners around the world.

Frontier economies: Frontier markets are smaller, more undeveloped, and riskier than emerging markets. They are economically less developed than the emerging economies. Frontier markets are thus the developing markets but better than the least developed markets.[7] Examples of frontier economies are Sri Lanka, Argentina, and Ghana.

Least developed economies: The least developed economies are the countries characterized by massive poverty, low level of human development, and economic vulnerability. In 2018, 47 nations were classified by UN as the least developed countries (LDCs)—Angola, Nigeria, Afghanistan, and Myanmar are the examples of LDCs.

Nature of Indian Economy

India—A Lower Middle-income Country

The World Bank classifies the world's economies into four income groups—high, upper-middle, lower-middle, and low. This assignment is based on GNI per capita which is calculated using the Atlas method.* For the year 2019, low-income economies are defined as those with a GNI per capita of $995 or less in 2017; lower middle-income economies are those with a GNI per capita between $996 and $3,895; upper middle-income economies are those between $3,896 and $12,055; and high-income economies are those with a GNI per capita of more than $12,055. Out of 218 countries, there are 34 low-income economies, 47 lower-middle-income economies, 56 upper-middle-income economies, and 81 high-income economies. With GNI per capita income of $1820, India is classified as a lower-middle income country.[8]

Third Largest and Fastest Growing Economy

At the time of independence, India was a backward nation with very less growth rate. The government through five-year plans tried to address such problems by laying down targets and ensured the allocation of funds for the development of different sectors. Till the first five plans, the average GDP growth was around 3.5%, and as a result, Indian economy failed to take off. During the post-reform period, the growth rate picked up, especially during 2004–2008, the country witnessed an average growth rate reaching an unprecedented high of 8.8% a year. Reaching an aspirational growth rate of 8% or higher and sustaining such growth momentum requires contributions from all domestic sectors and support from the global economy. While India's growth has been well diversified, the pace of growth acceleration has differed across sectors. The acceleration of value added has been fastest in services, followed by industry, and there has been no evident pattern of acceleration in agriculture.[9] As per world economic outlook 2018 report, India is the world's third largest economy in terms of purchasing power parity (PPP), after the China and the United States. India has become the sixth largest in terms of nominal GDP surpassing France. India is forecast to overtake the UK to become the world's fifth largest economy in 2019 and projected to surpass Japan to feature at the second position in the Asia-Pacific region by 2025.[10]

Higher Population Growth and High Dependency Ratio

World Bank noticed population growth rate of 1.1% in 2017. Population of India has increased from nearly 38 crore in 1951 to 136 crore in June 2019.[11] The country is passing through the third stage of demographic transition which is characterized by falling birth rate and death rate.[12] Higher population puts pressure on limited resource base of the country and causing deprivations to the masses that result into low per capita income of the nation. The pressure of population has also resulted in higher dependency ratio as well. Dependency ratio is (No. of

* A country's national income is converted into U.S. dollars using the Atlas conversion factor, which uses a three-year average of exchange rates adjusted for the difference between the rate of inflation in the country and international inflation. The resulting GNI in U.S. dollars is divided by the country's midyear population to obtain the GNI per capita.

persons in age group 0–14 years + No. of persons in age group 60 years or more) ÷ No. of persons in age group 15–59 years.[13] Dependency ratio gives the proportion of persons whom the persons in economically active age group need to support. Dependency ratio of India fell gradually from 79.1 in 1970 to 52.2 in 2015.[14]

Wide Scale Poverty and Unemployment

Almost 72 years have elapsed since India got independence but we are still the home for the world's largest number of poor people. On the basis of NSSO 68th round, 29.5% of population in India was below poverty line during 2011–12. Around 27.5% of India's population was multi-dimensionally poor in 2015 as per Multi-Dimensional Poverty Index released by Oxford Poverty & Human Development Initiative. Unemployment rate in India as per the current daily status was 5.6% as per NSSO 68th round for the year 2011–12. The Centre for Monitoring Indian Economy (CMIE) estimated that 11 million jobs were lost in 2018—pushing the unemployment rate to 7.38%.[15] The labor force participation rate for females has also revealed a declining trend. But what is more worrisome is the rise in educated unemployment in India. The unemployment rate is 4.6% for those who had completed between the sixth and the ninth standard. For those with qualifications between the 10th and the 12th standard, the unemployment rate was uncomfortably high at 10.6%. For graduates and post-graduates, it rose even higher to 13.2%.[16]

Low Level of Savings and Investment

Savings are vital as they lead to investment and cause increase in gross domestic product. In the western world, the private sector contributes almost 80% of total savings and household and the government sector does rest of the savings. However, in India, it is household sector which contributes around 60% in total domestic savings. During 1990–91, situation was worse as household sector contributed as high as 84% of total savings. The problem with household sector savings is that in a country like India the per capita income is low that results in higher consumption pattern and low savings. Further, it also indicates poor business and entrepreneurship profile of the country. However, in the past few decades, especially after the post-reform period, the private sector participation in the economy has increased multi-fold resulting in the increasing share of private sector and the decreasing share of household sector in aggregate domestic savings. Further, investment profile of the country has improved over the past few decades but it still lacks in certain aspects. The gross domestic capital formation in India has decreased from 39% in 2011–12 to around 29% in 2018–19. Finance holds the key to India's long-term sustainable growth. As the economy becomes larger and market-oriented, the financial sector needs to play a critical role in channeling savings into productive investments. For example, the two biggest challenges of investment in India at present are investment in infrastructure and in micro, small, and medium enterprises.[17]

Low Level of Human Development

The term human development denotes the process of widening people's choices and the level of their achieved wellbeing. India has emerged as the third largest and one of the fastest growing economies but its human development report card is dismal. The low level of human development gets reflected into poor education, lack of affordability and accessibility to basic healthcare

facilities, and lower level of economic well-being, which ultimately results in lower productivity of the nation as a whole. India's Human Development Index (HDI) rank is 130 out of 189 nations for the year 2017. As per Inequality adjusted HDI, India experiences a loss of 26.8% due to inequality in the distribution of the HDI dimension indices. The status of women in India is also not good which is reflected through different indices. For every 100,000 live births, 174 women die from pregnancy-related causes; and the adolescent birth rate is 23.1 births per 1,000 women of ages 15–19. Female participation in the labor market is 27.2% compared to 78.8 for men.[18]

From Agriculture Predominance to Service Led Growth

The share of agriculture as a percentage of GDP has come down from 53% in 1950–51 to around 15% in 2017–18. On the contrary, the share of services has increased from 30.3 to 54% during the same period. This transition of economy from agriculture to service sector is called service led growth phenomenon. Generally, as an economy progresses, it transmutes itself from an agriculture-based economy to an industrialized economy and finally into a service led economy. But in Indian case, the industrial development could not take place as envisaged by our policymakers. The contribution of industry in country's GDP has increased from 16.6% in 1950–51 to 31.2% in 2017–18. In contrast, in China, the share of agriculture, industry, and services is 7.2, 40.7, and 52.2%, respectively.[19] One more thing which has serious implication is the share of respective sectors in employment. For example, in the United States, agriculture contributes 4% of GDP and absorbs 4% of country's workforce. In the United Kingdom too, agriculture contributes 2% of GDP and provides employment to around 2% of the workforce. Comparatively, agriculture in India contributes 15% of GDP and employs around 45% of country's workforce. Thus, the service sector which generates maximum national income provides lesser employment, a phenomenon called as "jobless growth."