Thus, an initial deposit of Rs. 1000 with the SBI has created deposits of Rs. 2952 (= 1000 + 800 + 640 + 512). The process of credit creation goes on and come to an end when deposits become too small to generate any new loan. The entire banking system will create credit of Rs. 5000 with the initial deposit of Rs. 1000. This has been worked out using the deposit multiplier formula as under:

$$d = \frac{1}{r} \times \Delta D$$

where r = CRR (20%) and AD = initial change in the volume of deposits (Rs. 1000). $1/r$ is the deposit or credit multiplier. Thus,

$$d = \frac{1}{20\%} \times 1000$$

$$d = \frac{100}{20} \times 1000$$

$$d = \text{Rs. } 5000$$

This means all other banks will make deposits of Rs. 2048 (5000 – 2952).

But there are limitations to credit creation by banks. These are the following:

1. The total amount of cash reserves in the banking system. Larger the cash reserves more will be the credit creation.
2. Cash reserve ratio fixed by the central bank. More is the ratio, less is the power to create credit and vice versa.
3. Banking habits of the people of the country. It means banking transactions through cheques, drafts, bills etc. Good banking habit results in keeping smaller amount of cash with the banks and therefore, more can be lent. This will create large credit.

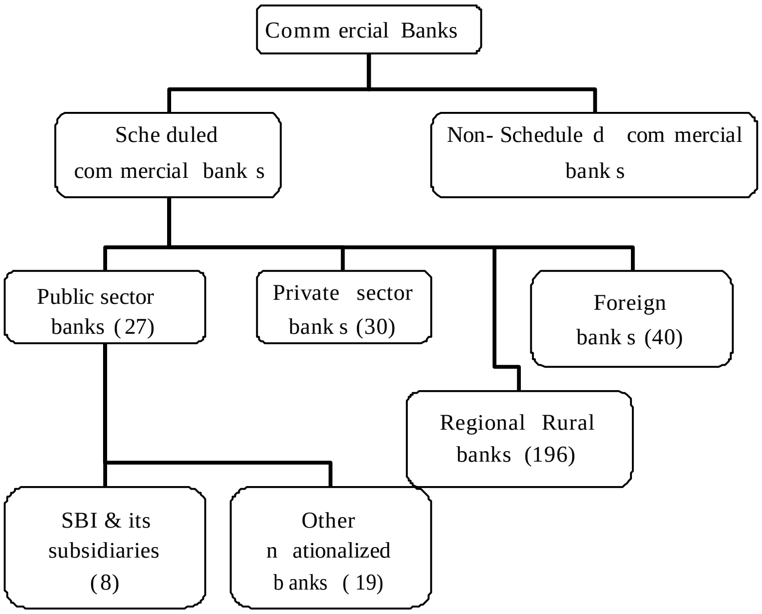
CLASSIFICATION OF COMMERCIAL BANKS

Commercial banks in India are classified mainly into two categories—Scheduled commercial banks and Non-scheduled commercial banks. Scheduled commercial banks are those which are entered in the Second Schedule of RBI Act, 1934. Such banks have a paid-up capital and reserves of an aggregate value of not less than Rs.5 lakhs and which carry out their operations in the interest of depositors. Non-scheduled commercial banks are those which are not entered in the list of the Second Schedule of RBI Act, 1934. Schedule commercial banks consist of – twenty seven public sector banks, thirty private sector banks of which twenty two are old private banks and eight are new, forty foreign banks and one hundred ninety six regional rural banks. Public sector commercial banks include the State Bank of India and its seven subsidiaries and other nineteen nationalized banks.

UNIT-9

CENTRAL BANK

A central bank is the apex institution in the banking and financial structure of the country. It plays a leading role in organizing, regulating, supervising and developing the banking and financial system of a country. Every country has a central bank known by different names. For instance, in India, it is known as Reserve Bank of India, while in England, it is the Bank of England and Federal Reserve System in USA. Reserve Bank of India was established on April 1, 1935.



A central bank is, however, different from commercial banks in many and important ways. First, it is not a profit making institution as commercial banks are. It acts in the public interest so as to control and regulate the banking and financial system of the country. Second, a central bank does not perform ordinary banking functions such as accepting of deposits from general public and lending advances to them. A central bank is owned and managed by the government of a country, whereas, commercial banks may be owned by government or private individuals as shareholders. Every country has one central bank but there are a number of commercial banks in the country.

FUNCTIONS OF A CENTRAL BANK

A central bank performs a number of important functions, which are discussed as under:

1. **Bank of Note Issue:** A central bank has been empowered to issue currency notes in the country. Currency notes issued by the central bank are the legal tender. The issue department of a central bank issues currency and coins. The central bank is required to maintain a certain amount of gold and foreign securities against the issue of notes.
2. **Banker and Adviser to the Government:** A Central bank acts as banker, agent and adviser to the government. As banker to the government, it receives the deposits of cash, cheques and drafts, etc., from the governments. It provides short term loans to the government and sells and buys foreign currencies on behalf of the government. It also manages public debt, issues new loans, receives subscriptions to these loans, pays interest on them and finally repays these loans. The central bank acts as the financial adviser to the government. It advises to the government on all financial and monetary matters and helps in formulating various economic policies.
3. **Banker to Banks:** As a bankers' bank, the central bank performs several functions. It acts as custodian of cash reserves of commercial and other banks. It also maintains

deposits of cash reserves as required by the commercial banks. It also discounts bills of commercial banks. It provides guidance to all banks and regulates their activities.

4. **Custodian of Foreign Reserves:** A central bank is the custodian of foreign exchange reserves of a country. All the foreign exchange transactions of a country are done through the central bank. It controls both the receipts and payments of foreign exchange. It helps in maintaining stability of the exchange rate by buying and selling foreign currencies in the market.
5. **Lender of the last Resort:** The central bank acts as the lender of the last resort. It provides ultimate need of finance to all banks by discounting approved securities and collateral loans and advances.
6. **Clearing House for Transfer and Settlement:** A central bank acts as a clearing house for transfer and settlement of mutual claims of the commercial banks. Since commercial banks keep their cash reserves with the central bank, it is easier and convenient to clear and settle claims between them by making transfer entries in their accounts maintained with the central bank.
7. **Controller of Credit:** The most important function of the central bank is to control credit creation by the commercial banks. Supply of credit must be regulated so as to ensure the smooth functioning of the economy. Central bank adopts quantitative and qualitative methods to control credit in the economy. Quantitative methods aim at controlling the cost and availability of credit, while qualitative methods influence the use and direction of credit.
8. **Promotional and Developmental Functions:** Central bank develops and promotes a strong banking system. It assists in the development of financial institutions like developmental banks to provide investible funds for the development of agriculture, industry and other sectors of the economy. It helps in the development of money and capital market in the country.

Questions for Review

1. Define a commercial bank.
2. Define a central bank.
3. What are the main functions of a commercial bank?
4. What are the main functions of the central bank of a country?
5. Central bank is the 'Lender of the last resort.'—explain.
6. Explain Gresham's law.
7. Explain how banks create credit.
8. What are the limitations to credit creation?
9. Distinguish between quantitative and qualitative credit control methods adopted by a central bank.
10. Distinguish between demand deposits and time deposits.
11. What is overdraft facility?
12. What is bank rate?
13. Give the meaning of open market operations.
14. What is cash reserve ratio?
15. What is moral suasion?

25 GOVERNMENT BUDGET— MEANING AND COMPONENTS

MEANING OF BUDGET

A budget may be defined as a financial plan or statement of the government which shows in details the estimated receipts and proposed expenditures and disbursements (payments) under various heads for the coming year. In other words, a budget is a description of the fiscal policies of the government–taxation and expenditure policies—and the financial plans in accordance to these. A budget indicates the revenue and expenditure of the last completed financial year, the probable revenue and expenditure estimates for the current year and the estimates of the anticipated revenue and proposed expenditure for the next financial year. For instance, the budget estimate for the year 2005–06 will contain:

1. Actual figures for the year 2004–05.
2. Budget and revised figures for the year 2005–06.
3. Budget estimates for the year 2006–07.

In short, budget reveals the basic character of fiscal policy of the government. It is the tool through which the government takes control of the economy. The budget is prepared and presented by the Finance Minister before the parliament at the beginning of each financial year. Under Article 112 of the constitution of India, a statement of estimated receipts and expenditures of the Central government has to be prepared for every financial year. By convention, the budget is presented on the last working day of February. In case of state budgets, the budget is presented before State legislatures. In both the cases, a general discussion is held. The general discussion relates to review and criticism of the government with regard to budgetary proposals. Then the budget is submitted to vote and voting on the demands for grants is taken. When the demands have been voted, a Finance bill is passed to approve the tax proposals. Finally, an Appropriation Bill is passed to authorize expenditure. Thus, a budget is said to be passed when Appropriation Bill and Finance Bill are passed. Appropriation Bill includes all grants for the year whether votable or non-votable. It is moved when demands for grants have been moved by the House. It is also called Money Bill. Finance Bill embodies the proposals of the government to levy new taxes, modify the existing taxes or continue the same.

COMPONENTS OF BUDGET

The budget is presented in two parts – **revenue budget** and **capital budget.** Revenue budget shows receipts of the government and the expenditures met from these revenues. Thus, it consists of revenue receipts and revenue expenditure. Capital budget shows capital requirements of the government and various ways of financing these expenditures. It comprises capital receipts and capital expenditures of the government.

The following table shows the budget structure of the government of India.

(Rs. in crore)

	2003–2004 Actuals	*2004–2005 Budget Estimates*	*2004–2005 Revised Estimates*	*2005–2006 Budget Estimates*
1. Revenue Receipts	**263878**	**309322**	**300904**	**351200**
2. Tax Revenue	186982	233906	225804	273466
3. Non-Tax Revenue	76896	75416	75100	77734
4. Capital Receipts (5 + 6 + 7)	**207490**	**168507**	**204887**	**163144**
5. Recoveries of Loans	67265	27100	61565	12000
6. Other Receipts	16953	4000	4091	–
7. Borrowing and other liabilities	123272	137407	139231	151144
8. Total Receipts (1 + 4)	**471368**	**477829**	**505791**	**514344**
9. Non-Plan Expenditure	**349088**	**332239**	**368404**	**370847**
10. On Revenue Account of which	283502	293650	296396	330530
11. Interest Payments	124088	129500	125905	133945
12. On Capital Account	65586	38589	72008	40317
13. Plan Expenditure	**122280**	**145590**	**137387**	**143497**
14. On Revenue Account	78638	91843	89673	115982
15. On Capital Account	43642	53747	47714	27515
16. Total Expenditure (9 + 13)	**471368**	**477829**	**505791**	**514344**
17. Reveune Expenditure (10 + 14)	362140	385493	386069	446512
18. Capital Expenditure (12 + 15)	109228	92336	119722	67832
19. Revenue Deficit (17 – 1)	**98262**	**76171**	**85165**	**95312**
20. Fiscal Deficit {16 – (1 + 5 + 6)}	**123272**	**137407**	**139231**	**151144**
21. Primary Deficit (20 – 11)	**–816**	**7907**	**13326**	**17199**

Revenue Budget

As stated above revenue budget consists of revenue receipts and revenue expenditure. These are discussed as under:

UNIT-10

Ref – Intro to Economics, By *Dutta*, New Age Pub

Revenue receipts of the government are all those receipts which are non-redeemable. These comprise tax revenue and non-tax revenue. Tax revenues consist of proceeds of taxes and duties levied by the government. Non-tax revenues consist of interest and dividends on investments made by the government and fee and other receipts for service rendered by it.

Tax revenue is an important source of revenue receipts of the government. There are varieties of taxes imposed by the government in India. The three important sources of tax revenue are—income tax, custom duties and excise duties. Apart of these there are capital taxes such as estate duty, wealth tax and gift tax.

Income Tax: Income tax is imposed by the government on the income of individuals and firms. In India, income tax is divided into two categories—agricultural tax income and non-agricultural tax income. The taxation of agricultural taxation is a matter for the state legislation and that of non-agricultural taxation is a central subject. Non-agricultural income taxes are of two types—personal income tax and corporate tax. Personal tax is levied on the income of the individuals. The tax is imposed on the aggregate incomes from all sources. Total taxable income is calculated on the basis of salaries, income from house property, profits and gains of business or profession, capital gains and income from other sources. The income tax is based on principle of ability to pay. Everybody is not required to pay income taxes.

Corporate tax is levied on the income/profits of the all companies, irrespective of their scale of operation. It is payable by way of advance payment and not like income tax which is deducted at source.

Government also levies various taxes on property and capital transactions such as wealth tax, gift tax and estate duty. *Wealth tax* is imposed on accumulated wealth or property of individuals, Hindu undivided family and closely held companies. The main idea for imposing this tax is to reduce inequalities in income and wealth. According to Gift Tax Act, 1958, a *tax on gifts* has been imposed by the government. The tax is imposed either on donor or recipient when a gift is made exceeding a certain amount. *Estate duty* is levied on the capital value of all property passing on the death of a person to his heirs. These are all direct taxes or taxes on income and property. Let us now explain indirect taxes or taxes on commodities. Custom duties and excise duties are the two important types of commodity taxes.

Custom duties are taxes imposed on commodities imported into or exported from India. In India, custom duties are mainly composed of import duties. Import duties are mostly ad valorem in nature. Ad valorem means duty imposed as a percentage of the price of the product.

Excise duties are imposed by the central government on the goods produced (mostly industrial goods) within the country. Excise duty covers a wide range of commodities. The excise duties may be fixed with reference to the value, weight, volume, or unit.

The other sources of government's revenue are non-tax revenues such as interest receipts, dividends and profits and other non-tax revenue.

Interest receipts include interest on loans by the central government to state governments, union territories, interest payable by Railways and telecommunications and interest on loans from public sector enterprises, cooperatives etc.

Dividends and profits consist of profits of Reserve Bank of India, nationalized banks and Life Insurance Corporation of India (LIC). It also includes dividends of The General Insurance Corporation (GIC), The Industrial Development Bank of India (IDBI) and other non-banking financial institutions.