



CONTENTS

UNIT	TITLE	PAGE No.
BLOCK-I : ENVIRONMENT - AN INTRODUCTION		1
Unit-1 :	Business Environment - An Overview	2
Unit-2 :	Economic Environment	16
Unit-3 :	Political & Legal Environment	37
Unit-4 :	Technological Environment	57
Unit-5 :	Socio-Cultural Environment	67
Unit-6 :	Business Ethics and Corporate Governance	81
BLOCK-II : STRUCTURE OF THE INDIAN ECONOMY		96
Unit-7 :	Economic Planning in India	97
Unit-8 :	Structural Dimensions of Indian Economy	120
Unit-9 :	Sectoral Dimensions of Indian Industry	137
Unit-10 :	Privatisation	159
Unit-11 :	Small Business	172
BLOCK-III : ECONOMIC POLICIES		189
Unit-12 :	Industrial Policies	190
Unit-13 :	New Industrial Policy, 1991	201
Unit-14 :	Monetary Policy	216
Unit-15 :	Fiscal Policy	222
Unit-16 :	Financial Sector Reforms	230
BLOCK-IV : EXTERNAL SECTOR		243
Unit-17 :	Indian Foreign Trade and EXIM Policy	244
Unit-18 :	India's Balance of Payments	263
Unit-19 :	Foreign Capital and Collaboration	274
Unit-20 :	Multi-National Corporations	292

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BLOCK-I : ENVIRONMENT - AN INTRODUCTION

Business of to-day or tomorrow is governed by external forces. In the changed scenario, businesses may make or mar depending upon their adaptation to new rules of the same. Philip Kotler comments "today you have to run faster to stay in the same place".

It is imperative that the changes in political-legal, technological, economic, socio-cultural and natural environmental factors to a great extent affect business enterprises in terms of their survival, growth, expansion etc. Hence, the firms must keep constant vigil on these forces, which are complex in nature. In fact many companies fail to see change as opportunity. They ignore or resist changes until it is too late. Their strategies, structures, systems, and organisational culture grow increasingly obsolete and dysfunctional. Even the prestigious organisations like Tatas, Birlas, Reliance etc., also have passed through difficult times because they ignored macro-environmental changes too long.

In this context, in this block, an attempt has been made to introduce you the subject of Business Environment in great detail including ethics of business and governance of corporate sectors too. First Unit highlights on Business Environment - An overview. Economic environment of business in India is discussed in the second unit. Political Environment, Social & Cultural Environment are discussed in the Unit-3, 4 and 5 respectively. Business Ethics and Corporate Governance is analysed in the Sixth Unit.

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UNIT-I: BUSINESS ENVIRONMENT-AN OVERVIEW

Objectives

After studying this unit you should be able to :

- Understand the meaning of the terms 'Business', 'Environment' and "Business Environment";
- Examine the scope of business, business goals, and contemporary business objectives; and
- Know the benefits of environmental study, the process of environmental analysis and its limitations.

Structure

- 1.1 Introduction
- 1.2 What is Business ?
- 1.3 Scope of Business
- 1.4 Business Goals
- 1.5 Contemporary Business Objectives
- 1.6 What is Environment ?
- 1.7 Knowing the Environment
- 1.8 Objectives and Uses of Environmental Analysis
- 1.9 The Process of Environmental Analysis
- 1.10 Limitations of Environmental Analysis
- 1.11 Organisation for Analysis
- 1.12 Summary
- 1.13 Self - Assessment Test
- 1.14 Further Readings

1.1 INTRODUCTION

Business is the product of technological, political, legal, economic, socio-cultural, global and natural factors amidst which it functions. There is symbiotic relationship between business and its environment and among the environmental factors. Simply put, business is influenced by its environment and in turn, to some extent it will influence the external forces. Similarly, political-legal environment influences economic environment and vice versa. The same is the relationship between other environment factors too.

The environmental factors are dynamic. They keep on changing as years roll by so does business. One should also know that a particular business firm, by itself, may not be in a position to change its environment. But along with other firms, business will be in a position to mould the environment in its favour, to a great deal. It is for the above reasons that an understanding of business and its environment is worth an attempt.

1.2 WHAT IS BUSINESS ?

Business may be understood as the organised efforts of enterprises to supply consumers with goods and services for a profit. Businesses vary in size, as measured by the number of employees or by sales volume. Large organisations such as Steel Authority of India Limited (SAIL) and Tata Iron and Steel Company Limited (TISCO) count their employees in the hundred thousands and their sales revenues in crores. But most business units in our country are small units independently owned and managed and employing fewer than twenty employees each.

Whether a business unit has one or two people working at home, 10 operating in a retail store, 1000 employed in a factory, or 100,000 operating in multiple units spread across the country, all businesses share the same purpose: **to earn profits.**

The purpose of business goes beyond earning profit. It is an important institution in society. Be it for the supply of goods and services; creation of job opportunities; offer of better quality of life; or contributing to the economic growth of the country and putting it on the global map; the role of business is crucial. Society cannot do without business. It needs no emphasis that business needs society as much.

1.3 SCOPE OF BUSINESS

The scope of business is indeed vast. Let us assume that you have decided to buy an automobile. Behind your purchase, there is the supplier of raw materials; there is the manufacturer who converts these raw materials and other inputs into usable vehicles; there is the dealer who makes the vehicles available at places convenient to you; there is the transport agent who assists in moving materials to the manufacturing plant and vehicles from plant to the market; there is the banker to finance various activities; there is the advertising agency which tells you about the vehicles, where and how they can be procured; there is the insurance agent who assumes risks on your behalf; and a host of other activities. Not only an automobile, even a simple item such as a ball pen necessitates a long chain of activities so as to make your purchase possible.

The multitudinous activities involved in bringing raw materials to the factory and the end product from there to the market constitute a business. In other words, business includes all activities connected with production, trade, banking, insurance, finance, agency, advertising, packaging and numerous other related activities. Business also includes all efforts to comply with legal restrictions and government requirements and discharging obligations to consumers, employees, owners and to other interest groups which have stakes in business directly or indirectly.

What is important and what needs emphasis in the term 'business' is that all the above activities are being organised and carried on with an important purpose, viz., earn profit by supplying goods and services to consumers to satisfy their felt needs. Thus, People occupy a central place around whom, by whom and for whom business is run. Business is people.

1.4 BUSINESS GOALS

Before we discuss business objectives, it is desirable to be clear about the meaning of three concepts, viz., vision, mission and objectives.

Vision

Vision refers to the goals that are broadest, most general, and all inclusive. A vision describes aspirations for the future, without specifying the means necessary to achieve those desired ends. The most effective visions are those that inspire, and this inspiration often takes

the form of asking for the best, the most or the greatest. It may be the best service, the most rugged product, or the greatest sense of achievement, but it must be inspirational. The vision statement of Birla 3M is: "To be the most innovative enterprise and the preferred supplier".

Mission

A vision becomes tangible as a mission statement. Writing such a statement specifies a leader's belief about an organisation and the direction in which it should move. It can also identify what is unique about the character of the organisation. The mission statement of Ford Motor Company is a typical illustration of the mission. Ford's mission statement reads thus:

"Ford Motor Company is a world leader in automotive and automotive-related products and services as well as in newer industries, such as aerospace, communications, and financial services. Our mission is to improve continually our products and services to meet our customers' needs, allowing us to prosper as a business and to provide a reasonable return for our stockholders, the owners of our business."

Many organisations develop both a vision statement as well as mission statement. Whereas the vision statement answers the question "what do we want to become?", the mission statement answers "what is our business?"

1.5 CONTEMPORARY BUSINESS OBJECTIVES

Mission statements are more specific than vision statements, but are not to be taken as concrete directions for action. Objectives render mission statements more concrete. In other words, mission statements seek to make a vision more specific and objectives are attempts to make mission statements more concrete. In short, they are compatible to each other. Objectives, therefore, represent the operational side of an organisation.

It may be stated that a typical business unit seeks to achieve more than one objective and there are always restraints to the attainment of some objectives. Objectives vary with the passage of time. Objectives common to most contemporary businesses are explained here.

1. Profit:

Making profit is the primary goal of any business enterprise. Profit is the excess of income over expense. Profit is the main incentive, motivator, strong sustainer, judicious allocator of resources, objective indicator of productivity and a solid basis for growth, expansion and survival. Profit enables a businessman to realise his other objectives too.

Not all enterprises are interested in making profits. For example, hospitals, schools, charitable institutions and government agencies are not basically concerned with the acquisition of profits. The non-profit enterprises customarily rely on gifts, endowments, receipts from money raising projects, subsidies or taxes for sustenance. The basic objective of these establishments is the provision of a service which is socially desirable and useful.

In profit-making enterprises, profit should not be the end in itself. Profit should be the beginning - acting as seed money for more products, more plants, more dividends, more tax payments, more jobs and more opportunities. Profits should promote the well-being of all... the rich and the poor; privileged and less privileged; consumers and producers and investors and non-investors. Ignoring this and overemphasizing profit may bring early death to an enterprise.

For instance, wrote George R. Terry, "promoting only products with high margins (to earn profits), ignoring research, and failing to provide working conditions satisfactory to employees may in the ultimate, bring about the demise of an enterprise."

2. Growth :

Growth is another primary objective of business. Business should grow in all directions over a period of time. An enterprise which remains stagnant for long is presumed to suffer from an organic defect.

The strategies adopted to achieve growth are:

- (a) add more products/markets;
- (b) diversify into new areas;
- (c) integration-forward or backward;
- (d) increase market share;
- (e) expand markets; or
- (f) cut down costs and increase productivity.

3. Power :

Business houses have vast resources (in the form of money, materials, men and know-how) at their command. These resources confer enormous economic and political power on owners and managers of business ventures. Next to the Prime Minister and Chief Ministers, perhaps, it is the business people who enjoy considerable clout in our country. Some businessmen mince no words in expressing the desire that they want more power. The late Aditya Birla used to assert that he built his empire to get more power.

Several enlightened businessmen have used their power for the good of society. One such illustration in our country was J.N. Tata, who passed away in 1904. He was a pioneer in industry, research, health care, art, literature and in many other areas. His name inspires awe and respect. It is hard to imagine what would have happened to the industrial map of our country if J.N. Tata had not been born in 1839 in a family of Parsi priests in Gujarat. "He was above all a patriot", wrote The Times of India (April 13, 1912) "who made no public speeches. To his mind, wealth and the industry which led to wealth, were not ends in themselves, but means to an end, the stimulation of the latent resources of the country and its elevation in the scale of nations."

4. Employee Satisfaction and Development :

"If you want to plan for a year, plant corn. If you want to plan for 30 years, plant a tree. But if you want to plan for 100 years, plant men" so goes a Chinese proverb. Business is people, said we, in the beginning of this unit. Caring for employee satisfaction and providing for their development has been one of the objectives of enlightened business enterprises.

Concern for employees continues to be an important aspect of management, contrary to the expectation that human element will lose its significance thanks to automation. In fact, quality of personnel is considered to be one of the hallmarks of best managed and highly respected companies.

The Tatas are a legend in pursuing this objective. Either in implementing labour welfare measures, constituting safety and security measures, or in providing training and development facilities, the name of Tatas should be mentioned first.

5. Quality Products and Services :

Providing quality products and services is yet another objective of business. Those who insisted on and persisted in quality survived competition and stayed ahead of others in the market. Persistent quality of products earns brand loyalty, a vital ingredient of success. Hindustan Lever is flourishing mainly because of the quality of its products. Some of its products like Liril, 5

Vim, Lifebuoy, Surf, Rin, Sunlight, Close-up, Lux, Rexona, Pears and others have become household names throughout the country. These products are accepted by buyers as safe, of high quality and reasonably priced. Behind its quality products, Hindustan Lever has an excellent Research and Development (R&D) set-up and a high degree of professional management. The company is sitting pretty and is almost invincible.

There are other business people who believe in quick money. Quick money comes through short-cuts. These are the people who give us razor blades which fail to give us one smooth and neat shave, bulbs that do not give at least 100 light hours of service, leaky taps and adulterated goods. Such enterprises will not survive for long.

6. Market Leadership :

To earn market leadership is yet another objective of business. To earn a niche for oneself in the market, innovation is the key factor. Innovation may be in product, advertising, distribution, finance or in any other field. Blow Plast retains its market leadership by introducing soft luggage bags and totes. Hindustan Lever earned leadership in tooth paste by introducing mouth-washer in its 'Close-up'. Asian Paints adopted unconventional channels for the sale of its paints, which has pushed them ahead of their competitors. Ambani of Reliance Textiles introduced convertible debentures which have become attractive. This and other financial wizards enabled Reliance to receive unprecedented response from investing public to any of its issues of securities.

7. Challenging :

Business offers vast scope and poses formidable challenges. Success in a business venture smacks of the abilities of individuals who own and failure betrays their inability and incompetence. The worth of an individual is tested more in business than in any other profession.

For Ratan Tata running business has been a challenge. Confessed Tata in an interview thus: "I have asked myself this quite often. I don't have monetary ownership in the company in which I work and I am not given to propagating the position I am in. I ask myself why I am doing this and I think it is perhaps the challenge. If I had an ideological choice, I would probably want to do something more for the uplift of the people of India. I have a strong desire not to make money but to see happiness created in a place where there isn't".

8. Creation of New Products and Services :

It is through business strategies new ideas and innovations are given a shape and are converted into useful products and services for the benefit of customers.

Although it may be too difficult to list all the products and services that business houses have provided us till now, it is interesting to mention that in the coming two or three decades, the following will receive considerable attention from researchers and business people:

- Readily available artificial human organs, except the brain.
- A means of transportation without an automobile, perhaps an individual flying machine.
- Drugs to cure or prevent cancer and the common cold.
- A pocket sized personal/business computer- i.e. a laptop or palm computers.
- Clothing that can be cleaned by placing it in a 'cleaning chamber' for one minute.
- A synthetic material to replace wood.
- A simple injection to determine the sex of an unborn child.

Will there be a greater joy to a businessman coming out with a drug which can cure cancer? Its availability in the market will be of benefit to those who need it.

9. Service to Society :

Business is a part of society and has several obligations towards it. Some of them are:

- (i) providing safe and quality goods at reasonable prices;
- (ii) providing employment;
- (iii) patronising cultural and religious activities;
- (iv) supporting less privileged sections of people in society like Scheduled Castes and Scheduled Tribes, the physically handicapped, women and children.

Services of society is the main objective of a non-profit-making enterprise. Profit-making enterprises cannot afford to have service as the primary objective. It will be a secondary objective.

10. Good Corporate Citizenship :

Good corporate citizenship implies that the business unit complies with the rules of the land, pays taxes to the government regularly, discharges its obligations to society and cares for its employees and customers.

Bending rules of the land, evading tax payments by under-invoicing exports and dubious tax planning; cornering licences at the cost of others; adulteration of quality products; and indulging in other unethical practices may earn money. But such practices hardly speak highly of corporate citizenship. The Tatas are a contrast to the general trend. Unethical practices are anathema to the Tatas. The best way to substantiate this claim is to quote J.R.D. Tata. "This factor has also worked against our growth. What would have happened if our philosophy was like that of some other companies which do not stop at any means to attain their ends. I have often thought of that and I have come to the conclusion that if we were like these other groups, we would be twice as big as we are today. What we have sacrificed is a 100 percent growth."

Activity-A

1. Can you enumerate other business objectives?

2. Name the various changes that have taken place since independence in our country.

3. Name the authors of the book "In Search of Excellence"

1.6 WHAT IS ENVIRONMENT?

Environment refers to all external forces which have a bearing on the functioning of business. "Environment factors or constraints", wrote Barry M. Richman and Melvyn Copen, "are largely if not totally, external and beyond the control of individual industrial enterprises and their managements. These are essentially the 'givers' within which firms and their managements must operate in a specific country and they vary, often greatly, from country to country"

The business environment poses threats to a firm or offers immense opportunities for potential market exploitation. Stressing this aspect, William F. Glueck and Lawrence R. Jauch wrote thus: "The environment includes factors outside the firm which can lead to opportunities for or threats to the firm. Although there are many factors, the most important of the sectors are socio-economic, technological, supplier, competitors, and government."

As per the second definition, environment includes such factors as socio-economic, technological, supplier, competitor and the government. While all these are highly relevant, there are two more factors which are not included in the definition, and which exercise considerable influence on business. They are physical or natural environment and global environment. Including these two, the total environment of business, for our purposes, will include six factors, viz., political-legal, economic, social-cultural, technological, global and natural. As can be seen in the subsequent units, all these factors are explained in great detail. A brief description of each, however, follows in the following paragraphs.

Technological environment exercises considerable influence on business. Technology is understood as the systematic application of scientific or other organised knowledge to practical tasks. It is through business that technology reaches people. Technology changes fast and to keep pace with it, businessmen should be ever alert to adopt changed technology in their businesses.

Economic environment refers to all forces which have an economic impact on business. Industrial production, agriculture, planning, basic economic philosophy, infrastructure, national income, per capita income, money supply, price level, population, savings, stages in the economic development and trade cycles are major factors which make up the total economic environment. There is close relationship between business and its economic environment. Business obtains all its needed inputs from the economic environment and it absorbs the output of business units.

Political environment refers to the influence exerted by the three political institutions, viz., legislature, executive and the judiciary in shaping, directing, developing and controlling business activities. The legislature decides on particular course of action; the executive, also called the government, implements whatever was decided by the parliament and the judiciary functions as the watch dog in order to ensure that both the legislature and the executive function in public interest and within the boundaries of the Constitution. A stable and dynamic political environment is indispensable for business growth.

Notwithstanding spectacular advancements made in science and technology, man's attempt to conquer nature has not met with total success. He has no answer, for example, for the flourishing affluence co-existing with stark poverty; severe droughts and devastating floods occurring in sickening regularity; and some other such phenomena. Man still finds himself helpless before mighty nature. Business, an economic pursuit of man, continues to be dictated by nature. To what extent business depends on nature and what is the relationship between the two constitutes an interesting study.

Yet another environmental factor which is fast emerging as the force to reckon with is the global or international environment. Thanks to liberalisation, Indian companies are forced to view business issues from a global perspective. Business responses and managerial practices must be fine-tuned to survive in the global environment. A manager must understand that safe and protected markets are no more there; that the world is becoming small in size thanks to advanced means of transport and communication facilities; that learning of foreign languages is a necessity; that acquiring familiarity with strange and changing currencies is a must; that facing political and legal uncertainties is inevitable; and that adapting their products to different customer needs and tastes would only help companies survive amidst intense competition. Implications of the global environment are elaborated in one of the subsequent sections.

Social and cultural environment refers to the influence exercised by certain factors which are beyond the company's gate. Such factors include people's attitude to work and wealth; role of family, marriage, religion and education; ethical issues and social responsiveness of business. Social and cultural environment is highly relevant for a business unit as the variety of goods it produces, the type of employees it gets and its obligation to society depend on the cultural milieu in which the firm operates.

Thus, business is the product of the technological, political-legal, economic, social-cultural, global and natural factors amidst which it functions. Three features are common to this web of relationship between business and its environment. First, there is symbiotic relationship between business and its environment and among the environmental factors. In other words, business is influenced by its environment and in turn, to a certain degree, it will influence the external forces. Similarly, political-legal environment influences economic environment and vice versa. The same is the relationship between other environment factors too.

The second feature is that these environmental factors are dynamic. They keep on changing as years roll by, so does business.

The third feature is that a particular business firm, by itself, may not be in a position to change its environment. But along with other firms, business will be in a position to mould the environment in its favour, to a large extent.

1.7. KNOWING THE ENVIRONMENT

The environment, as described above, provides a mass of ambiguous information. What should be done to make out the relevance of the information? What is to be accepted and what rejected? Three related concepts seek to answer these questions. They are : (i) the enacted environment, (ii) the domain and domain consensus, and (iii) the task environment.

Enacted Environment : An organisation seeks to create its own environment out of the total external environment. The environment which the organisation creates is called enactment. Enactment implies that the organisation creates a relevant environment for itself by aggressively scoping, narrowing and scanning the external environment. In effect, the organisation creates the environment to which it reacts. It does not react to the entire environment.

Domain and Domain Consensus : The domain is that part of the enacted environment which the organisation carves out for itself. The firm delineates its own territory out of the environment.

The delineated territory comprises the range of products offered, population served and services rendered. The organisation focuses its efforts on these three areas while paying less attention to other areas.

As is well known, an organisation has many stakeholders-owners, employees, customers, government, public, suppliers and lenders. Domain Consensus is formed when all the stakeholders agree upon the domain of the organisation.

When domain consensus is not reached, conflicts can arise regarding parts of the environment which should be monitored. This conflict causes confusion and backbiting, when the company is blindsided by an unexpected occurrence from a poorly monitored sector.

Task Environment : This specifies the range of products to be offered, the technology to be employed and the productive strategies to be used to counter the global competition. It is the task environment which needs constant surveillance, though elements outside are not ignored, but are paid less attention.

1.8 OBJECTIVES AND USES OF ENVIRONMENTAL ANALYSIS

Environmental analysis has three basic goals. First, the analysis should provide an understanding of current and potential changes taking place in the task environment. It is important that one must be aware of the existing environment. At the same time, one must have a long term perspective too.

Secondly, environmental analysis should provide inputs for strategic decision making. (See Fig. 1.1). Mere collection of data is not enough. The information collected must be used in strategic decision making.

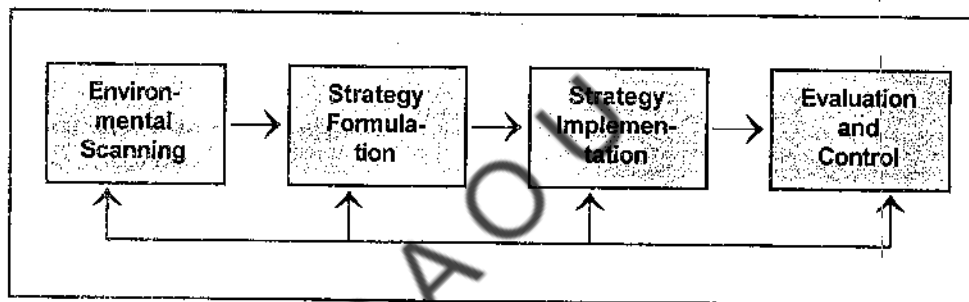


Figure 1.1

Linkage Between Environmental Scanning and Strategic Management

Thirdly, environmental analysis should facilitate and foster strategic thinking in organizations—typically a rich source of ideas and understanding of the context within which a firm operates. It should challenge the current wisdom by bringing fresh viewpoints into the organisation.

To be specific, the benefits of environmental study are as follows:

1. Development of broad strategies and long-term policies of the firm.
2. Development of action plans to deal with technological advancements.
3. To foresee the impact of socio-economic changes at the national and international levels on the firm's stability.
4. Analysis of competitors' strategies and formulation of effective counter-measures.
5. To keep oneself dynamic.

William. F. Glueck and Lawrence R. Jauch have stressed the negative consequences of failure to study the environment. They have written that, **"In the years between 1918 and 1968, almost half of the 100 largest American firms went out of business or became significantly less important to society. Often, a company becomes convinced that it is almost invincible and does not have to examine what is happening in the market place. When the company ceases to adjust the environment to its strategy or does not react to the demands of the environment by changing its strategy, the result is lessened achievement of corporate objectives."**

They went on to stress that “Environmental analysis and diagnosis give strategists time to anticipate opportunities and to plan to take optional responses to these opportunities. It also helps strategists to develop an early warning system to prevent threats or to develop strategies which can turn a threat to the firm’s advantage”.

Without a systematic environmental search and diagnosis, the time pressure of the managerial job can lead to inadequately thought out responses to the environmental changes. It is clear that because of the difficulty to assessing the future, not all future events can be anticipated. But some can and are. To the extent that some or most are anticipated by this analysis and diagnosis, managerial decisions are likely to be better. And the process reduces the time pressures on the few which are not anticipated. Thus, the managers can concentrate on these few instead of having to deal with all the environment opportunities and threats in the pressure-cooker environment.

“Firms which systematically analyses and diagnose the environment are more effective than those which don’t”.

In order to further substantiate the benefits of environmental analysis, it may be said that the real value of the analysis inheres in the **product** of the analysis as well as the **process** of engaging in it.

At the product level, the outputs of environment analysis generally consist of (1) descriptions of changes **currently** taking place, (2) harbingers of **potential** changes in the future, and (3) alternative descriptions of **future** change. Together, they provide descriptions of alternative futures. Such descriptions provide organisations with **lead time** to identify, understand and adapt to external issues, to anticipate the consequences of the environmental trends, and to develop well thought out positions and policies. In addition, lead time enables an organisation to convert emerging issues from threats to opportunities.

At the level of process, environmental analysis underscores the notion that organisations are necessarily pervious to the influence of outside forces. When conducted properly, this leads to the enhanced capacity and commitment to understanding, anticipating and responding to external changes on the part of the firm’s key strategic managers. Responsiveness is achieved by inducing managers to think beyond their task or industry environments, often forcing them to reflect upon their cognitive biases. In short, at the process level, environmental analysis offers one basis for organisational learning.

1.9 THE PROCESS OF ENVIRONMENTAL ANALYSIS

Environmental analysis is a challenging, time consuming and expensive affair. The analysis consists of four sequential steps : **(i) scanning (ii) monitoring (iii) forecasting, and (iv) assessment.**

Scanning - Being the first step in the process of environmental analysis, scanning involves general surveillance of all environmental factors and their interactions in order to (a) identify early signals of possible environmental change, and (b) detect environmental change already under way.

Scanning is ill-structured and ambiguous environmental analysis activity. The potentially relevant data for scanning are unlimited but are scattered, vague, and imprecise. The fundamental challenge for analysis in scanning is, therefore, to make sense out of vague, ambiguous, and unconnected data.

Monitoring - Monitoring involves tracking the environmental trends, sequences or events, or streams of activities. It frequently involves following signals or indicators unearthed during environmental scanning. The purpose of monitoring is to assemble sufficient data to discern

whether certain trends and patterns are emerging. Thus, as monitoring progresses, the data turn frequently from imprecise to precise.

Three outcomes emerge out of monitoring : (a) a specific description of environmental trends and patterns to be forecast; (b) the identification of trends for further monitoring, and (c) the identification of areas for further scanning. These outputs(particularly the first) become inputs for forecasting. They will also cause for further scanning and monitoring.

Forecasting - Scanning and monitoring provide a picture of what has already taken place and what is happening. Strategic decision-making, however, requires a future orientation. Naturally, forecasting is an essential element in environmental analysis.

Forecasting is concerned with developing plausible projections of the direction, scope, and intensity of environmental change. It tries layout the evolutionary path of anticipated change. For example, how long will it take the new technology to reach the market place? Are current life-style trends likely to continue? These kinds of questions provide the grist for forecasting efforts.

Unlike scanning and monitoring, forecasting is well focussed and is much more deductive and complex activity. This is so because the focus, scope and goals of forecasting are more specific than the earlier two stages of environmental analysis.

Assessment - Scanning, monitoring and forecasting are not ends in themselves. Unless their outputs are assessed to determine implications for the organisation's current and potential strategies, scanning, monitoring and forecasting simply provide 'nice-to-know' information. Assessment involves identifying and evaluating how and why current and projected environmental changes affect or will affect strategic management of the organisation.

In assessment, the frame of reference moves from understanding the environment - the focus of scanning, monitoring and forecasting - to identify what the understanding means for the organisation. Assessment, therefore, tries to answer questions such as what are the key issues presented by the environment, and what are the implications of such issues for the organisation?

Linkages among Stages

Though conceptually scanning, monitoring, forecasting and assessment are separate activities, they are inextricably intertwined(See Fig. 1.2).

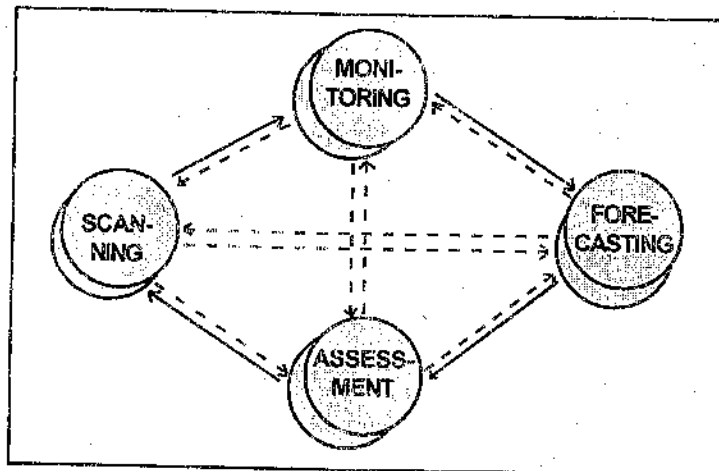


Figure 1.2
Linkages among the Stages

For example, upon unearthing an emerging trend through scanning, one might quickly jump to potential implications for the organisation (assessment) by implicitly forecasting the

future path of the trend. If warranted by the potential impact, one may then continue scanning and monitoring. Also, forecasting often proves difficult, if not impossible, because of insufficient knowledge and data about the topic or trends being forecast, thus forcing a return to scanning and monitoring efforts. Deriving implications (assessment) often allots the organisation to the need to conduct further scanning, monitoring and forecasting. Thus, environmental analysis is not as simple and as linear as moving from scanning to monitoring to forecasting to assessment.

1.10 LIMITATIONS OF ENVIRONMENTAL ANALYSIS

Environmental analysis, as with any other analysis, has certain limitations. These limitations are:

1. Environmental analysis does not foretell the future, nor does it eliminate uncertainty for any organisation. Thus, organisations that practice environmental analysis sometimes confront unexpected events - events not anticipated during environmental analysis. Environmental analysis, however, should reduce the frequency and extent of surprises that may confront a company.

2. Environmental analysis on and off itself, is not a sufficient guarantor of organisational effectiveness. It is only one of the inputs in strategy development and testing.

3. The potential of environmental analysis is often not realised because of how it is practised. It is sometimes used as a crutch for post-hoc reflections. At times managers place uncritical faith in the data without thinking about the data's verifiability or accuracy.

4. Too much reliance is often placed on the information collected through environmental scanning. When there is overloading of information, one is likely to get lost and become inactive - typical of '**paralysis through analysis syndrome**'.

Take the case of Norton Company, an industrial abrasives manufacturer and a competitor of 3M in the U.S. Norton faithfully studies environment and followed all management models, systems and procedures. In spite of all Norton's state-of-the-art management systems, its performance remained disappointing. Persistently poor results left the company vulnerable and, in 1990, it was absorbed into the French giant, Compagnie de Saint-Gobain.

Meanwhile, 3M achieved success but following a different path. The company did not get caught by the paralysis syndrome. Leaders here placed little emphasis on top-down planning and control. Instead, they nurtured the innovative ideas of sales engineers and sales representatives, thereby building an entrepreneurial engine that generated stream of profitable new products and promising new technologies. Going into post-war boom, 3M and Norton were roughly the same size. By the mid-1980s, 3M was reporting sales eight times those of its old competitor. Ironically, just as Norton was swallowed up by Saint Gobain, 3M was named for the fifth time in six years to Fortune's list of the ten most admired corporations.

Success lies in adventure and strategic risk taking. It eludes those who hesitate to step forward. Environmental analysis often makes an individual too cautious in his approach and he is likely to be overtaken by events. So, this analysis should be strategically done.

1.11 ORGANISATION FOR ANALYSIS

Who does analysis in a typical organisation? This is a relevant question. The answer is everybody who holds some post in the organisation. To be specific, the top executive, marketing manager, financial manager and purchasing manager are the people who could assume the responsibility. The Production Manager may not be able to contribute much because his job demands that he should confine his time and energy to the shop floor. Some organisations

maintain Management Information Systems (MIS) which can be utilised to handle the job of analysing environment. The best alternative is to have an exclusive department for the purpose to be headed by a competent official. This would entail additional expenditure but the additional cost is worth considering the risk involved in not considering the changes taking place in the environment.

Whatever may be the organisational arrangement, one should understand that environmental analysis is an activity that requires people, resources, and time. Someone in the organisation must spend the time to do the requisite analytical tasks involved in environmental analysis. Resources beyond people are often required : money to fund data collection, to buy outside analysis capability, or to support internal analysis efforts. Much managerial time is often consumed in organising to carry out the analytical tasks inherent in environmental analysis: deciding who should do what in collecting, analysing, and interpreting data; and creating the organisational processes such as task forces, adhoc teams, or working groups required to effect these tasks.

Activity - B

List the Companies/Firms/Corporations which are super performers in India.

Activity - C

Differentiate between the terms "Forecasting and Planning".

Activity - D

Name the company corresponding to the products indicated below.

<i>Product</i>	<i>Name of the company</i>
1. Vicks	_____
2. Matiz Car	_____
3. Liril/Rexona	_____
4. Amrutanjan	_____
5. Red Lable Tea	_____
6. Thums-up	_____

Activity - E

Name the first top five richest business people in our country:

- 1.
- 2.
- 3.
- 4.
- 5.

1.12 SUMMARY

In this unit, the external forces which have bearing on the business is highlighted. The minute details about business, its objectives, scope are dealt with. Further, the environmental analysis, process and limitations have been discussed. Various examples are covered at appropriate places in the entire Unit. In the subsequent unit each environmental factor is discussed in great detail.

1.13 SELF - ASSESSMENT TEST

1. What is business? How does business of today differ from that of four to five decades ago?
2. "Firms which systematically analyse and diagnose the environment are more effective than those which don't" - Elucidate.
3. "Environmental scanning should provide inputs for strategic decision making" - Elaborate.
4. "Profit making is the primary goal of any business enterprise". - Yes or No - Discuss.

1.14 FURTHER READINGS

1. Gita Piramal, Business Maharajas, New Delhi, Viking, 1996.
2. George A Stainer and John F- Steiner, "Business, Government and Society, McGrawHill, 2000.
3. Fahey and Narayanan, Macro Environmental Analysis for Strategic Management, West Publication Company, 1986.
4. Glueck and Jauch, Business Policy and Strategic Management.

UNIT-2 : ECONOMIC ENVIRONMENT

Objectives

After reading this unit, you should be able to:

- digest the economic environmental factors
- understand the basic economic systems
- know the economic reforms and the recovery
- get the claims and counter claims
- know the future economic scene
- have the glimpse of the second generation reforms.

Structure

- 2.1 Introduction
- 2.2 Economic Factors
- 2.3 Claims and Counter Claims
- 2.4 Agenda for Future
- 2.5 New Economic Policy
 - 2.5.1 Background to the New Policy
 - 2.5.2 The New Policy
 - 2.5.3 Evaluation of the Policy
- 2.6 The Second Generation Reforms
- 2.7 Summary
- 2.8 Self - Assessment Test
- 2.9 Further Readings

2.1 INTRODUCTION

Economic environment refers to all those economic factors which have a bearing on the functioning of a business unit. Business depends on the economic environment for all the needed inputs. It also depends on the economic environment to sell the finished goods. Naturally, the dependence of business on the economic environment is total and it is not surprising because, as it is rightly said, business is one unit of the total economy.

The importance of economic environment is reinforced by the fact that more and more economists (business economists to be precise) are finding place in industrial establishments. Dr. Pendse was the economic adviser to the Tatas for a long time. Richard Freeman is the Chief Economist of ICI, an American company. These two are not isolated instances. There is the Society of Business Economists in England, whose membership now is more than 600. All these members are employed in different industries, if not as economists, but in planning, marketing or finance areas. Thus, trained economists supplying macro-economic forecasts and research are found in major companies in manufacturing, commerce and finance department.

2.2 ECONOMIC FACTORS

It is difficult to be precise about the factors which constitute the economic environment of a country. It is equally difficult to draw the lines of distinction between the political environment and the economic environment and the technological environment. The type of monetary policy, dear money policy or cheap money policy, that the government wants to pursue may be partly political and partly economic. Again, importing a particular technology may be political, economic, or both. It was for this reason that in the previous unit itself mentioned that all these environmental factors of business are closely interdependent.

Coming to the economic environment, we list the following factors which for our purpose, constitute the economic environment of business. We are not confining ourselves to pure economic principles such as the law of demand and supply, marginal utility and the like. We include major macro-economic factors which have considerable influence on business. Such factors are:

- Economic Systems
- Economic Planning
- Industry
- Agriculture
- Infrastructure
- Financial and Fiscal Sectors
- Removal of Regional Imbalances
- Price and Distribution Controls
- Economic Reforms
- Human Resources, and
- Per Capita and National Income.

All these have been explained below :

Basic Economic Systems

An economic system of a country refers to the form of economic organisation constituted by the mode and method of production, kinds of economic entities and institutions, the objectives and functions of the economy directed towards satisfying people's wants. According to Professor Halm "In all economic systems the basic problem is the allocation of scarce means among the competing ends for the achievement of maximum results". The fundamental problem for an economy is to provide answers to the following fundamental questions:

- i) **What to Produce :** What type of goods should be produced from the given limited resources and in what quantities?
- ii) **How to Produce :** How these derived goods shall be produced, i.e. who shall produce and what methods shall be adopted?
- iii) **For Whom to Produce :** For whom to produce and how these goods shall be distributed?

Just as there are two political philosophies, viz., democracy and totalitarianism, there are three distant economic philosophies, viz., Capitalism, Socialism, and Communism. The system of **capitalism** stresses the philosophy of individualism believing in private ownership of all agents of production, in private sharing of distribution processes that determine the functional rewards of each participant, and in individual expression of consumer choice through a free market

place. In its political manifestation, capitalism may fall in a range between extreme individualism and no government (anarchism) and the acceptance of some State sanctions as mentioned by Adam Smith and the later philosophers of modern capitalism.

Mention should be made of the Welfare State concept which has developed in recent years. This is a modification of modern capitalism that provides for an increasing degree of State regulation when certain deficiencies appear in the economy. These limitations placed on the free market operations such as Workmen's Compensation Law, provision for social security, laws regulating industrial relations, or direct State financial aid to housing and agriculture, to name but a few, are accepted as a result of the members of a democracy becoming dissatisfied with certain conditions that prevailed or might prevail without these measures. The Welfare State is short of State socialism in that it does not sanction the public ownership of the activities that are regulated. Some, in fact, argue that the acceptance of certain welfare State objectives is necessary to provide flexibility for capitalism, otherwise it might become static and be destroyed because of certain faults. Welfare actions then become modifications within the framework that constitute the basic postulates of capitalism. USA is the best example for capitalism.

Under **socialism**, the tools of production are to be organised, managed and owned by the government, with the benefits accruing to the public. A strong public sector, agrarian reforms, control over private wealth and investment and national self-reliance are the other planks of socialism.

Socialism does not involve an equal division of existing wealth among the people but advocates the egalitarian principle. It believes in providing employment to all and emphasises suitable rewards to the efforts put in by every worker. Also called Fabian socialism, this philosophy is followed in our country and other social democratic countries in the world.

Communism goes further to abolish all private property and property rights to income. The State would own and direct all instruments of production. Sharing in the distributive process would have no relationship to private property since this right would not exist. Alternatively called Marxism, communism was followed in Russia, China and East European countries.

Table 2.1 draws a comparison among the three economic systems.

Table 2.1: Capitalism, Socialism and Communism Compared

<i>Characteristics</i>	<i>Capitalism</i>	<i>Socialism</i>	<i>Communism</i>
Economic Markets	Freedom to compete with the right to invest	Limited Competition with State-owned industries	Absence of competition with State-owned markets and industries.
Individual Incentives	Profits and wages in relation to one's ability and willingness to work	Profits recognised Wages fairly in relation to efforts	Profits not allowed. Workers urged to work for the glory of the State.
Capital Sources	Capital invested by owners who may also borrow on credit. Capital may be reinvested from profits. Depreciation is legal	Obtained from owners and from State-issued bonds for State-owned industries. Depreciation permitted	State provides all resources to start business owned by the State; No depreciation
Labour	Workers are free to select an employer and an occupation	Workers allowed to select occupation. State planning encourages employment.	The State determines one's employer and employment.

<i>Characteristics</i>	<i>Capitalism</i>	<i>Socialism</i>	<i>Communism</i>
Management	Managers are selected on the basis of ability. Managers have freedom to make decisions	Managers in State-owned industries are answerable to the State. Non-monetary rewards emphasised	Key managers must be party members. Absence of freedom to make decisions.
Business Ownership	Individuals have the right to own a business and to contract with others.	State owns the basic industries. Other businesses may exist	State owns all productive capacity including communes.
Risk Assumption	Losses assumed by owners. May transfer business risks to other businesses through insurance	People assume risks of State-owned industries. Losses taken from taxes	Economic production owned by the State. Risks assumed by the State. Losses reduce standard of living.

(Source: Vernon A Musselman and Eugene H Hughes, Introduction to Modern Business-Issues & Environment, p.20)

Each economic philosophy has its own strength and weakness. Capitalism, for example, encourages individual initiative, allows the market forces to have free play, promotes a competitive spirit, and directs the scarce resources to most profitable uses. The weakness of capitalism stems from the fact that it results in gross inequities of income, recurrence of trade cycles because of the free play of market forces, exploitation of the poor by the rich, and corrupt influence of vested interests over the State. Capitalism results in the wastage of resources. It has devastating effect on environment. Finally, people in capitalist societies earn more and consequently indulge in excessive and wasteful expenditure on consumer durables and luxuries.

In common parlance, the terms socialism and communism are used interchangeably. The East European countries are often called socialist countries though they follow Marxist ideologies.

The great October Revolution of 1917 saw, for the first time, emergence of a state based on Marxist principles. It was Lenin who set-up a communist state in Russia and from here, the ideology spread to Czechoslovakia, Poland, Hungary, Rumania, Yugoslavian and China. Firmly entrenched in these countries, communism appeared to have answers for all the ills associated with capitalism. But cracks developed within the edifice built over a period of more than six decades. The structure started crumbling all of a sudden. We recently witnessed country after country going back on communism and almost embracing capitalism. Several reasons have contributed to the reversal of the Marxists economy. These reasons incidentally testify to the inherent weakness of communism.

The major weakness of Marxism is the denial of individual freedom. One of the essential requirements of human organism is freedom - to work, to earn, to express, to choose and to indulge in the expenditure of one's choice. This freedom is denied to people. The followers of Marxist believed that the ideology would guarantee individual freedom. This expectation was belied as it became clear in the communist countries. No individual freedom existed in these countries, contrary to the theoretical claims made about it.

Secondly, communism assumes total commitment of people to work and to contribute to the country's welfare. This has not been forthcoming from people in the communist countries. People worked more or less as they work under capitalism, being driven by the twin forces of the carrot and the stick. Infact, there was more slackness and more pilfering on the part of the

workers and probably more corruption on the part of the management than in the capitalism societies.

Thirdly, the communist economies failed to achieve significant economic growth. The rate of growth of these economies has been markedly lower than that of the economies relying on market forces. One of the most striking failures of state or collective ownership has been in agriculture where a super-power like Soviet Union, possessing one-sixth of the land surface on earth, found itself unable to feed its people even after 70 years of revolution.

Fourthly, equality which was the main plank of Marxists, did not succeed in the communist countries. The basic principle that every organised society is subject to stratification very much applied to communist societies also. Years back, therefore, the communist motto of "for each according to his ability to each according to his need" was changed in the Soviet Union without fanfare and almost surreptitiously to "from each according to his work". The Stalinovites made a big dent into the communist theory by being given economic rewards for their work and the differentiation that has been subsequently introduced consists not so much in the money wage but payments in kind and in privilege to those who occupy higher positions in the hierarchy; this, if translated into money, would show a very substantial difference.

Fifthly, the rulers themselves did not set fine examples for the followers to emulate. Lenin lived, till the end of his life, in one room in Kremlin whereas Brezhnev lived in the equivalent of many palaces and owned a fleet of most expensive of the world's cars. Late Ceausescu and his wife in Romania lived in style and led a pompous life. Public anger against the couple was so much that together they died being shot by prosecutors mercilessly. More than 300 bullets were found on the dead bodies of Ceausescu and his wife. The number of bullets bear testimony to the public wrath against the leaders who proclaimed equality but did not practise it.

Sixthly, communism has been obsessed with the rights of workers. This obsession has led to the tendency to strike work, often on unjustifiable grounds. Walk in the streets of Calcutta or Thiruvananthapuram, you will find red flags hoisted at every business or industrial establishment. Public sector units have been taken as private properties to enjoy and squander.

Seventhly, the followers of communism seem to have several contradictions. One such contradiction which is too conspicuous is the attitude towards religion. Seventy years of communist rule in the erstwhile USSR did not help to eradicate religion. Same is true in West Bengal and Kerala.

Finally, communism collapsed because of its inherent weakness - lack of flexibility and the absence of resilience. Capitalism survives because of its flexibility. It abandons the market where the survival of people is at stake. Look at the way the government intervenes in chosen areas even in the US economy.

Socialism seems to fall between capitalism and communism, partaking the strong points of both the philosophies and avoiding their weaknesses at the same time. It is for this reason that several developing countries of Asia, Latin America and Africa have adopted socialistic philosophy.

But the experience of several countries, particularly the African bloc, belies the expectations planned on socialism. As the Economic Times of July 6, 1986 commented, the "common error of African rulers was to stick with economic policies derived from the half-understood European socialism of 1950s and earlier. Governments, they seem to have thought, could create wealth by decree. People's untidy lives could be improved by government management. So they set up huge bureaucracies (which they could not afford to pay properly, and which, therefore, become corrupt as well as idle) to regulate every aspect of life. They paid for government projects from funds that were meant to pay for crops, and held down food prices so that farmers subsidised towns-people. They passed laws saying that foreign currency could be exchanged only at a

rate far below what the market said it was worth”.

We chose mixed economy, a midway between capitalism and communism, as our economic philosophy. Closely resembling socialism, the concept of mixed economy admits the existence of private enterprises along with public ownership. The economic set-up under this philosophy is split up into three parts:

- Sectors in which both production and distribution are entirely managed and controlled by the State to the complete exclusion of private enterprise;
- Sectors in which the State and private enterprise jointly participate in production as well as in distribution; and
- Sectors in which the private enterprise has complete access subject only to the general control and regulation of the State.

The Industrial Policy of 1956 has clearly demarcated the areas meant for each of these three sectors of the economy. The concept of mixed economy has guided our economy for the past three-and-a-half decades and probably would continue to do so in the years to come.

Looking back, “we have reason to be satisfied”, asserted Mr. R. Venkataraman, the then Vice President of India, while delivering G.L. Mehta Memorial Lecture in 1986, “with the progress that has been achieved on this path (economy) under very difficult circumstances - external and internal. This is not to deny, by any means, that we have a long way to go in achieving our basic objectives of employment and poverty eradication or to underplay the difficulties and distortions that might have been experienced in the pursuit of mixed economy”.

The mixed economy has its share of criticisms. It has, for example, not enabled its followers to become either Americans or Russians. The mixed economy has been approximately compared to the amber colour on a signal post which keeps the driver of a vehicle guessing about what his next move should be.

Activity A

Does mixed economy really help Indians’ economic growth? Give reasons.

Activity B

What are the objectives of Ninth Five Year Plan (1997-2002)

Economic Planning

A mixed economy is necessarily a planned economy. It does not mean simply a controlled economy in which, the government interferes in economic matters through fiscal and monetary policies, but it is an economy in which the government has a clear and definite economic plan. The public sector will have to operate according to certain priorities and to realise specific social and economic goals. Naturally, the public sector should have an economic plan. At the same time, the government cannot leave the private sector to function in its own unorganised way.

The government has to prepare and implement a comprehensive economic plan integrating the private sector with the public sector. It is for these reasons that we have been having economic planning since 1951 when the First Five Year Plan was launched.

We have had four decades of economic planning. We have completed eight five-year plans. All the five-year plans were designed to achieve four important long-term objectives, viz.,

- Increase production to the maximum possible extent so as to achieve a higher level of national and per capita income;
- Achieve full employment;
- Reduce inequalities of income and wealth; and
- Set up a socialist society based on equality and justice and the absence of exploitation.

Massive investments were made in all the five-year plans to realise these objectives.

Table 2.2 gives the allocations of the plans.

Table 2.2 : Pattern of Resource Allocation in India's Plans

Heads of Development	I	II	III	IV	V	VI	VII	VIII
Agriculture & Irrigation	37.0	20.9	20.5	23.3	22.1	22.2	20.2	20.6
Power	7.6	9.7	14.6	18.6	18.8	16.7	17.4	18.7
Industry	4.9	24.1	22.9	19.7	24.3	26.5	23.7	18.8
Transport & Communication	26.4	27.0	24.6	19.5	17.4	16.0	17.1	18.7
Social Services	24.1	18.3	17.4	18.9	17.4	18.6	21.6	23.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(Source : Economic Survey and Planning Commission Annual Report 1995-96)

Industry

In the mid-1960s, India had a better industrial base and possessed more pre-requisites for industrial growth than South Korea, Malaysia, Taiwan, Thailand and Indonesia. Since then, the country has succeeded in creating a virtually autarkic economy, where all outputs and factors were subject to rigid price and quantity controls; where investment was strictly rationed; where there were multiple barriers to entry, investment, foreign trade, and competition, and where the objective of the financial system was to supply subsidised development funds irrespective of returns. Consequently, all the countries, mentioned above, have overtaken India and are far ahead in industrial growth.

The various administrative controls (many of which owe their origin to the rationing era of World War II and which are still in force) are industrial licensing, product reservation for public sector, MRTP and asset classification of monopolies, product reservation for the small scale sector, Foreign Exchange Regulation Act, tariffs and quotas, the mini-plant fetish, labor market rigidities, development finance and indigenous availability and essentiality. All these have been explained in greater detail in subsequent sections. But, the faith in mini-plants, availability and essentiality have been highlighted here.

The Mini-Plant Fetish: In the 1970's, the government began to believe that mini-plants constituted appropriate technology, notwithstanding strong evidence to the contrary. Such plants were encouraged through fiscal concessions and subsidised development finance. There was, consequently, a mushrooming of mini-cement, mini-paper, mini-sugar and mini-steel plants. None of these were technically viable, fell short of economies of scales and could only exist under a regime of subsidies, high tariffs, severe quotas and purchase preferences. The subsequent losses of the plants hardly prevented their promoters from reaping huge rents in the initial years. In the 1980s, as the financial situation worsened, and the economy gradually opened up, incentives and concessions disappeared. Today, almost all these mini-plants are incurably sick and are awaiting liquidation.

Indigenous Availability and Essentiality : In the late 1960s and 1950s, any manufacturer who wanted to import capital goods or components had to satisfy the Directorate General of Technical Development (DGTD) that the item was essential and was not locally available. Essentiality gave enormous discretionary powers to the officials of DGTD, while indigenous availability means advertising in trade journals. If an Indian firm could claim to produce the item, this had to be examined by the DGTD, which conferred upon domestic capital goods manufacturers the power to delay imports. Coupled with high tariffs and quotas, this allowed the Indian capital goods industry to sell machinery at inflated prices. Increases in project costs of users were justified by reference to the high shadow price of dollars, and rectified by subsidised development finance.

The Reforms and the Recovery

There is a general agreement that the reforms have yielded positive results. Statistics speak for themselves. GDP rose impressively by 7.2% in 1994-95 and accelerated to 7.5% in 1996-97, but fell to 5% in 1997-98. For the first time since the 1950s, India has achieved a growth rate of 7%. A significant contribution to this achievement has come from industry as revealed in Table 2.3.

Table 2.3 : Composition of GDP

(Percentage Share)

Sector	1951-52 to 1955-56	1985-86 to 1989-90	1993-94	1994-95	1996-97	1997-98
Primary	56.06	34.48	31.20	31.26	26.90	25.00
Secondary	15.63	26.57	27.50	27.53	30.90	31.00
Tertiary	28.31	38.95	41.30	41.21	42.20	44.00
	100.00	100.00	100.00	100.00	100.00	100.00

But a second look reveals that we have a long road to traverse to reach a comfortable stage. India needs higher growth and greater exports. We need 7% of sustained growth in GDP over the next five years coupled with 20% annual growth in exports. These rates sustained

over a long period will help us service external debt, achieve significant growth in employment and reduce absolute poverty.

These targets need means. Some of them are external to firms, such as good port facilities, better roads, efficient telecommunications, adequate power supply, proper management of fiscal deficit and exchange rates, and a stable macro-economic regime. While these are undoubtedly important determinants of sustained growth, an excessive pre-occupation with external factors results in ignoring the role of the internal organisation of firms—namely, the policies that need to be introduced to ensure healthier corporate governance, better monitoring of a firm's performance by banks and financial institutions, incentive enhancing reforms in corporate laws and capital market regulations, flexibility in factor use, efficient debt renegotiations, faster restructuring of viable companies, and the speedy exit of unviable ones. Unfortunately, these have only been peripherally touched upon in the reform program until now. Major changes in these areas still await implementation.

National Income and Per Capita Income

Every sector of the economy employs natural, human and material resources and contributes to the aggregate flow of goods and services during a time period, usually specified as one year. This aggregate flow of goods and services represents the total income earned by factors of production employed during the year and is popularly called national income or national product. The rate of growth of the national income in an economy is an indication of the pace at which the economy has been growing. A high growth rate indicates that the economy is a developed one. Low growth rate signals that the economy is a developing or a poor one.

Furthermore, a high national income indicates that the economy is developed and the overall environment is favourable for business growth.

Table 2.4 gives details about national income and per capita income since 1980.

Table - 2.4 : National Income and Per Capita Income at Current Prices

	National Income (Rs. Crore)	Per Capita Income (Rs.)
1980-81	1,10,685	1,630
1990-91	4,18,074	4,983
1991-92	4,79,612	5,602
1992-93	5,45,434	6,255
1993-94	6,26,957	7,060
1994-95	7,44,663	8,237
1995-96	8,56,663	9,473
1996-97	9,85,162	10,708

Looking at the figures available in Table-2.4, it may be stated that our performance compares favorably with that achieved by the currently high income countries when they were in their transformation phase. For example, our national income growth during 1950-1994 has been reported higher than that of the UK, France and Germany during the mid-19th to mid-20th centuries, and about the same as the performance of the USA which was one of the most developing nations at that time.

However, it must be admitted that our growth rates have been less than the plan targets (see Table 2.5) and below the required growth rate of about 10% per annum. Reasons are obvious.

The primary reason for low growth level in the national income is the deficiency in investment. This is followed by high capital-output ratio, low agricultural and industrial growth and population explosion. The last factor is mainly responsible for low per capita income, notwithstanding satisfactory growth in the national income.

Table-2.5 : Targets and Actuals in National Income

(Annual Percentages)

	Targets	Actuals
I Plan	2.1	3.6
II Plan	4.5	4.0
III Plan	5.6	2.4
IV Plan	5.7	3.3
V Plan	4.4	5.0
VI Plan	5.2	5.4
VII Plan	5.0	5.7
VIII Plan	5.6	5.7

Human Resource

Demographic factors and the extent of urbanisation go a long way in deciding economic growth which in turn determine the economic environment of the business. The density of population, the extent of their standard of living, the level of their education, the nature of their occupation etc., greatly influence the type of business the entrepreneurs could under take. Infact, human resources constitute an important constituent of the total economic environment. There are several reasons which bring out the crucial role of people in an economy. In the first place, people provide ready market for goods produced and services rendered by business establishments. With more than 93 crore people, our country offers a vast market. This explains the reason why MNCs are keen in investing their funds in India. Secondly, people together constitute one of the factors of production. It is not enough if a country has land and capital, it needs labour (humar resource) to put the other factors to proper use. Our country is endowed with a vast pool of scientists, technicians, administrators, managers, software experts, engineers, professors, doctors, civil servants, strategists, financial wizards and experts in marketing. All these professionals will help run organizations successfully, Thirdly, the degree of economic prosperity, for example, of a nation depends on the quality of its people. Japan's prosperity owes it to its people. The country has been able to reach its present status thanks to the motivated and hard working people. Lack of natural resources has not hindered the country's prosperity. Burma has all the ingredients to become rich-oil (first country in Asia to discover oil), foodgrains, timber, precious rubies, tungsten-but has failed to become one, thanks to its people who are generally not risk takers and majority of them are tribals. Same is the story with Sri Lanka. The country has rich potential to export natural rubber, tea, copra and precious stones. Thanks to the people who seem to believe more in violence and killings than in peace, Sri Lanka could not prosper economically. Fourthly, our economy has entered into a new and exiting phase thanks to the new economic policy measures initiated from the start of the 1990s. In order to sustain the momentum of growth, we need people with competence and motivation. Finally, people 25

need economic growth just as prosperity demands the services of individuals. Whatever is produced should be used by people. It is only then that the economy will have served its purpose.

Our country has more number of people than the economy could afford. Some statistics prove the point. In 1986, our population was around 760 million and 844 million (1990-91), comprising 392 million males and 367 million females. In 1961, our population was 439 million, 226 males and 213 million females. During the decade 1971-81, the growth rate has increased to 2.5% per annum, against 2.48% during 1961-71, and 2.1% during 1951-61. However, there has been a shift in the vital rates. During the decade 1971-81, the birth rate had declined to 15 per 1,000 population from 50.9 in 1971-81 and from 46.4 in 1961-71. In the case of females, it rose from 44.7 to 50 during the same period.

Table 2.6 shows the population trend in India.

There is another dimension to the problem of overpopulation. It is said that out of 185 nations in the world, we rank not first, second or 10th but 11th in population growth.

Table 2.6 : Population Trend

Year	Population	Year	Population
1901	23.80	1951	36.10
1911	25.20	1961	43.92
1921	25.10	1971	54.81
1931	27.90	1991	84.63
1941	31.87		

(Source : Eighth Five Year Plan, Vol. 1, and Census of India 1991)

It is also said that the population is growing more slowly than the world's two-thirds of the nations. Comparisons of this type have purely academic interest. The fact is, as we said earlier, we have too many mouths to feed and this has been a drag on our development.

However, it goes to the credit of our country that it was the first in the world to adopt family panning as a State policy. From the First Plan itself, the need to control population was recognised. During the Second Plan, though both these Plans indicated an official policy to control population, there was no effective implementation. The results of the 1961 Census confirmed the half hearted efforts at population control and imparted a new urgency to the programme. The Third Plan recognised, for the first time, family planning which till then had relied heavily on the traditional clinical referral approach.

The Fourth Plan described family planning as a programme deserving the highest priority. It introduced the time and target approach to family planning. The Fifth Plan continued to give this priority status to family planning. In April 1976, the population policy in India recieved a new impetus, when the government issued a statement in its national population policy. The statement contained several new measures and it reflected the government's realisation that the population explosion had reached a critical stage and was proving to be a major stumbling block in its efforts to raise the living standards of the masses. The programme underwent a change during the emergency, when it incorporated compulsory approach to family planning. In 1977, the nomenclature was changed to family welfare programme from family planning programme. During 1977-79, the performance of the programme was extremely poor. The Sixth Plan listed limited population growth as one of its main objectives. The Seventh and Eighth Plans too did emphasise the need for limited population growth.

All these efforts have not gone waste. The message of the red triangle has spread far and wide. It is gratifying to note that an illiterate villager now talks about the need for a small family and they accept family planning techniques with appreciation. A visit to government hospital in a small town is a sight to be believed. The beds in the hospital are ever full with young mothers undergoing treatment after they have undergone tubectomies. There is no need to talk about the problem in cities. People are aware of the need for and advantage of spacing child births and stopping after the first two. Seeds for better tomorrow are sown and the fruits will be reaped in the years to come.

Activity - C

1. Differentiate between budgetary deficit and fiscal deficit.

2. Differentiate between Government-oriented economy and market - oriented economy.

3. Why human resource is considered as an economic factor?

2.3 CLAIMS AND COUNTER CLAIMS

What has been the result of all these developmental efforts? There have been claims and counter claims about the outcome. Official agencies claim that huge investments produced positive results. But these claims are not acceptable to the economists, intellectuals and politicians who do not see eye to eye with the government agencies. What these claims and counter claims are?

On the achievement side, the claims made relate to industry, agriculture, infrastructure, foreign trade, growth rate of the economy, control of inflation and the standard of living of the people. It is asserted that significant progress has been made in all these and many more during the last four decades of economic planning.

The progress made by the Indian economy can be better appreciated by comparing economic performance during the Eighth plan period and its predecessor. The following are worth noting:

- Overall economic growth has been faster;
- The manufacturing sector has grown almost two per cent points faster per year in the Eighth Plan period;
- Agriculture and allied sectors have grown at about 3.5 per cent per annum in both periods;
- Both exports and imports have grown significantly faster in the Eighth Plan period;
- The balance of payments has strengthened considerably, with trade and current account deficits declining as ratios of GDP, while exports and imports have grown rapidly both in value terms as well as in proportion to GDP;
- The Central Government's fiscal deficit as proportion of GDP has declined significantly;
- The Average rate of gross domestic savings has risen substantially from 20.6% of GDP in the Seventh Plan period to 23.9% in the first four years of the Eighth Plan;
- With the exception of tele communications, the rate of growth of net output (value added) of infrastructure sectors has slowed down;
- The average rate of inflation has risen somewhat, though remaining below double digits.

Counter-claims are equally forceful. It is alleged that all is not well with our industrial sector. The sector is facing too many problems as will be described later. Many industrial units are facing the threat of closure. If the claims are really true, why should the country be pushed down from one among the top 10 industrialised countries in the world to one in 20 down below, ask the critics. About agriculture, it is alleged that the phenomenal increase in production of foodgrains is only in rice and wheat. Coarse cereals which are consumed by vast majority of villagers have not registered impressive increase in production. Besides, agriculture is highly dependent on monsoon, failure of which disrupts not only agriculture but the entire economy. The talk about achievements does not mean anything to the common man who still reels under poverty, illiteracy and ignorance. Then there is the ever increasing fiscal deficit.

The country has a huge unemployed population of 39 million (1995). China has little over five million. All other developing countries too have the problem of unemployment but not as much as India has.

Thus, the debate can go on. But what should not be lost sight of is the fact that our economy has remarkable resilience. This is borne by the fact that it faced two wars, successive droughts and floods, enormous expenditure on defence and is sustaining more than 93 crore plus people. Whatever the critics may say, the truth remains that, over the years, the life-style and levels of living of the people have vastly improved. Population below the poverty line too has declined as is evident from Table 2.7. The late Prime Minister Mrs. Indira Gandhi, was right when she said that wherever she went, she found smiles on the faces of people and this was the best indicator of economic prosperity that has taken place in our country.

Let us also forget fact that we have failed in one important dimension of economic development, and it is the building of national character, strong integrity, staunch patriotic fervour and exquisite moral standards, especially among the youth as also in the rest of our countrymen. It is sad that we hardly find young men or women who can proudly say that this is our land and this is our country. It is equally sad that we hardly come across individuals who are inspired by fanatical commitment to their work and to the country. We have managers who do not manage, workers who do not work, teachers who do not teach and students who do not study.

Table 2.7 : Population Below Poverty Line

	%
1983-84	30.1
1987-88	25.5
1993-94	19.0

(Source : Planning Commission, New Delhi)

2.4 AGENDA FOR FUTURE

Table 2.8 contains series of pressing questions which need satisfactory answers. These questions, incidentally, constitute the agenda for future.

Table - 2.8 : Key Questions

A. Macro-Economic Scene

1. What will be the likely growth of the economy?
2. What can be done to boost exports?
3. Can we achieve higher growth rate and sustain it?

B. Inflation and Exchange Rates

1. Why are interest rates high inspite of low inflation?

C. Poverty and Public Policy

1. What is the impact of reforms on poverty?
2. What has happened to antipoverty measures?

D. The Energy Scene

1. Why is there power shortage?
2. Can private power plants help meet the shortage?
3. How can we bridge the gap between demand and supply?

E. The Environment Scene

1. What are the pressing environmental problems?
2. How can we deal with air, water and noise pollution?
3. How do we manage our forest cover?
4. What is happening to the Indian biodiversity?

F. Agriculture and Rural Development

1. What reforms are needed at the agricultural front?
2. What can be done with agricultural subsidies?
3. What have we done for rural development?

G. Industry

1. What can we do to accelerate industrial growth?
2. What can be done to improve efficiency of PSEs?
3. What can be done to contain growing sickness?
4. How about corporate governance?

H. Labour Policy

1. What kind of labour policy reforms are needed?

I. Securities Markets

1. What have reforms done to improve market efficiency?
2. What are the roles of primary and secondary markets?
3. Why has the stock market slumped?
4. What role do FIs play?

J. Banking Sector

1. Have reforms improved the performance of public sector banks?
2. How should we improve the performance of the banking sector?

K. Transport

1. What are the problems of railways?
2. How should we improve railways' share of freight traffic?
3. What is the problem with roads and road transportation?
4. Has private entry benefited civil aviation?
5. How should we improve performance in ports and shipping?

L. Telecommunication

1. Why are our telecom services so poor?
2. How should DOT be regulated? What should be our telecom policy?

M. Planning

1. Why was planning undertaken in the first place?
2. Is delay on market mechanism justified?
3. What should be the role of planning?

Describing the various components of economic environment and leaving it at that serves no real purpose. What is important is to understand how the economic environment impacts an individual business firm. A chief executive should answer many questions as the following: How will my costs of operations change? Wage rates? Raw materials? Health and benefit costs of my employees? Interest rates on my borrowings? What new competition will I face in the global market? How will the unification of Europe affect my business? Will my competitors cut into my share of domestic market? How can I expand the demand for my products? How much should I spend on R&D? Answers to these and other related questions are available in the economic environment of business.

Activity - D

1. Name five Foreign Institutional Investors.

1. _____
2. _____
3. _____
4. _____
5. _____

2. What is Portfolio Investment?

2.5 NEW ECONOMIC POLICY

Since July 1991, the government has initiated a series of radical changes in its policies relating to industry, trade, finance, foreign investments and fiscal aspects. The various changes, also called structural adjustments, when put together, constitute an economic policy which marks a total departure from the policy pursued earlier. This section is devoted to a brief discussion of the various aspects of the new policy.

2.5.1 BACKGROUND TO THE NEW POLICY

The new economic policy was necessitated by the worst economic crisis which was never witnessed by the country after Independence.

The most visible sign of the country's economic crisis was its extremely low foreign exchange reserves of Rs. 2400 crore, which was reached in early 1991. The reserves were just enough to buy, from abroad, only three weeks requirements. The situation became even more precarious when international agencies lowered the country's credit rating.

The second major aspect of the economic crisis was the rapidly increasing burden of national debt, which exceeded 60 per cent of GNP in 1991. The fiscal deficit of the previous five years forced the government to borrow increasingly to meet shortfall in the revenue account. Borrowing added to the already prevailing debt burden.

The third and the most damaging feature of the 1991 crisis was the high price level. During 1985-90, the GDP grew at an average rate of 5.7 per cent but money supply increased at 15.7 per cent per annum. This excess liquidity led to high price rise which touched 17 per cent.

2.5.2 THE NEW POLICY

As part of the budget of 1991-92, through the latest one and also outside of the budgets, the government announced a number of economic reform measures. (It does not mean that attempts were not made earlier to reform the regulatory, trade and taxation regimes. It is just that their pace and frequency were slow).

The main objectives of the policy initiatives were:

1. Deregulation of Indian economic system;
2. Increasing the competitiveness of Indian industries;
3. Privatisation of Public Sector Undertakings;
4. Development of indigenous technology; and
5. Linking the Indian economy to the global market so as to acquire the ability to pay imports, and to make us less dependent on aid.

Thus, the new economic policy has four components, viz. (a) Liberalisation, (b) Privatisation, (c) Globalisation and (d) Stabilisation.

Together called the structural adjustment programme (SAP), the new policy envisages the measures as shown in Table 2.9.

The SAP has been forced on the economy because of several reasons. They are: (i) excess of consumption and expenditure over the revenue, resulting in heavy government borrowing, (ii) growing inefficiency in the use of resources; (iii) over protection; (iv) mismanagement of the firms and the economy, (v) distortions such as poor technological development and a shortage of foreign exchange and (vi) imprudent borrowing from abroad and mishandling and mismanagement of foreign exchange reserves.

2.5.3 EVALUATION OF THE POLICY

Two questions are relevant in the context of critical assessment of the new economic policy. They are: (i) Is the policy unavoidable? and (ii) What are the achievements and failures of the policy?

With regard to the first question, the answer is in affirmative considering the mire in which our economy was caught during the late 1980s and the early 1990s. A lasting solution to the crisis was not possible without the restoration of fiscal balance, infusing dynamism and competition and an increase in outward orientation.

Table - 2.9 : Model of Economic Management in India

<i>Pre-Reform Strategies</i>	<i>Economic Reform Strategies</i>
Closed Economy	Open Economy
Self reliance	Integrate with world markets
State-led economic growth	Market determined economic growth
Import substitution strategies	Export oriented strategies
Licence dominated regime	Delicensing, deregulation, debureaucratisation
Frequent state interventions	Selective and effective state interventions.
Political administered prices	Market determined prices at large.
No much concern for deficits	Contain all kinds of deficits
Monetary expansionary process	Deflationary monetary and fiscal policies.
PSUs as engines of growth	Private investment as growth engine
Dominance of PSUs	Withdrawal from the area of private interest.
Philosophy of natural monopoly	Minimise gap between public and private sector.
	Inducement to FDI and MNCs

Restrictions on currency movement	Liberalisation of restrictions
State controlled interest rates	Deregulation of interest rates
State controlled credit	Credit policy reforms
Underdeveloped capital market	Reforms in capital market
Huge public sector budgetary resources (PSBR) liability on the government.	Minimise PSBR
High tax rates	Tax reforms

As to the second question, it may be asserted that the results have been quite encouraging. There has been a remarkable surge in the growth rate of the economy. After the crisis induced low growth of 0.9 per cent in 1991-92, the economy has responded smartly to the economic reforms to record a growth of 6.8 per cent in 1996-97. Industrial growth has registered around 8 per cent per annum.

Exports have grown comfortably and foreign investment inflow has been exceedingly good. Consequently, foreign currency reserves (19.5 billion by mid February 1995) have stock piled. Price level too has been brought down to less than 8 per cent. And contrary to what the critics might say, poverty has come down.

In general, economy has become vibrant. Captains of industry are buoyant and are not deterred by the entry of MNCs. There is an overall increase in productivity, quality and competitiveness of Indian goods and services. For an economy which was under the grip of controls for nearly four decades, the new economic policy has not been a big jolt. It has absorbed the shocks of the structural adjustment with remarkable resilience and is looking ahead for more reforms. This has been realised by all political parties and hence the talk about the irreversibility of economic reforms.

There are problems nevertheless: (1) The pace of economic reforms, though fast during the first three years, slowed down from 1994 onwards. Reason is obvious. Elections to several state assemblies were held in 1994. Two Rupees a kg of rice was the main promise in elections to the Andhra assembly. The promise was accepted by the electorate and the party which promised highly subsidised rice won the landslide majority. This opened the eyes of the rulers in the Central Government. Suddenly there was talk about subsidies and poverty and all attention was focussed on these issues. Economic reforms were sidelined and the trend continues till to date.

(2) Though economic reforms are announced by the Central Government, their implementation is in the hands of state governments. For example, industries have been freed from investment and production restrictions. But basic infrastructure such as land, power and water needs are to be provided by the state governments and except Haryana, Kerala, Orissa, Punjab, Rajasthan, West Bengal and Maharashtra, other states have not responded favourably to the economic reforms. Without active support from the state governments, it is difficult to carry out the reforms successfully.

(3) The Central Government's fiscal deficit continues to be high and this is reflected in continuing inflationary pressure. The borrowing requirements of a high fiscal deficit are a source of pressure on interest rates and adversely affect the availability of resources for productive investment, especially at a time when a strong industrial recovery has resuscitated private sector demand for investible funds.

(4) Foreign exchange front may not continue to be comfortable for all the days to come. Unless fiscal restraint is observed and reforms in tax and trade policies continued, the recent improvements in international competitiveness and export growth could falter and thus bring the balance of payments under renewed stress. Moreover, in today's increasingly open and com-

petitive international environment, perceptions of weakness in macroeconomic policy of economic reforms could adversely affect the flow of foreign savings.

(5) Weakness in reforms is already visible. Not only the pace has slowed down, the process of reforms is not complete even though reforms are four years old. Many areas need policy changes. For example, throwing insurance to the private sector, phasing out subsidies, reducing the number of agencies which give clearance for new projects, amending the Companies Act, 1956 to allow amalgamations and inter-corporate investments, and the like await government's clearance.

(6) The reforms have hit the labour hard: Emboldened by the new economic policy, both public and private sector enterprises have resorted to voluntary retirement schemes to get rid off surplus labour. Surplus may be the labour force, but removal is not the ideal solution. Excess labour could be retrained and redeployed instead of being asked to go home for good.

The labour is hurt on the employment front too. As pointed out by the mid-term appraisal document of the Eighth Plan, "although employment growth was better in 1991-95 than during 1985-92, when the average rate of growth was only 1.78 per cent (equivalent to a net annual addition of about five million per year), it has been substantially lower than the Plan's target of an average employment growth rate of 2.6 to 2.8 per cent.

"Consequently, the growth in employment opportunities of six million in each of the three years 1992-95 have fallen short of the target envisaged in the Plan by about 2.5 million each year. It has also been smaller than the estimated growth of the labour force during the period. Therefore, the level of unemployment in the economy which was estimated at 17 million in 1992, is likely to have increased to 19 million in 1994". Obviously, economic reforms seems to have failed in generating additional jobs.

(7) The success of reforms is highly exaggerated. If one were to look into the economy closely, nothing seems to have changed from pre-reform days. The share of manufacturing in GDP, for example, was 27.5 per cent in 1989-90. It was slightly less at 27.3 per cent in 1994-95. The share of agriculture fell from 33.7 per cent in 1989-90 to 31.5 per cent in 1994-95.

(8) Contrary to what the policy makers claim, poverty during the nineties has worsened. The progress achieved during the eighties in poverty reduction got reversed or ground to a halt during the nineties.

All things considered, it may be stated that the reforms are inevitable. Our economy cannot remain isolated from what is happening in the global business scenario. However, the policy makers do well to realise the past mistakes and correct them on the way to further reforms.

2.6 THE SECOND GENERATION REFORMS

What has been accomplished till now through SAP is significant. Yet much needs to be done to reap the full benefits of what has so far been done. This calls for the implementation of the second generation reforms. The second generation reforms should help our firms grow and become strong MNCs, and offer greater opportunities to our vast pool of educated youth to realise their potential and alleviate the sufferings of people still languishing below poverty line.

In brief, the second generation reforms comprise the following:

A. Exploiting the Knowledge-based Global Economy

- (i) Revolutionizing the telecom sector to help intergrate India's economy into world economy.

- (ii) Building institutes for higher education to turnout competent youth to take advantage of newer opportunities.
- (iii) A system of intellectual property rights to reward innovations adequately.
- (iv) Venture capital and 'private equity funds' to finance risk projects of the knowledge-based economy.

B. Growing Indian Transnational Corporations

- (i) Indian firms to enjoy flexibility in entry and exit. Freedom to deversify and to close down unsuccessful units helps Indian companies compete successfully with MNCs.
- (ii) Bring in more trade reforms so that resources could be put to more productive uses.
- (iii) Liberalise domestic trade, besides freeing international trade.
- (iv) Liberalise and move towards capital account convertibility.

C. High Growth of Agriculture

- (i) Free farmers from all domestic restrictions on storage, transport and sale of agricultural products.
- (ii) State to ensure that adequate investments are made in irrigation, agricultural research and infrastructure.

D. Empowering the Poor

- (i) Integrate and consolidate anti-poverty measures.
- (ii) Set up a system for old age income security.

E. Human Development

- (i) Knowledge industries require educated people. Make primary education compulsory.
- (ii) Involve private sector to provide better primary education.

F. Clean Environment

- (i) Arrest damage to environment.
- (ii) Promote clean and healthy environment.

G. Improvements to Governance

- (i) Reform of public finance
- (ii) Rationalise electricity prices
- (iii) Bring in legal reforms that ensure inexpensive and speedy justice and at the same time facilitate economic growth.

Activity - E

Can economic process be reverted? Give reasons.

Activity - F

What are the shortcomings of New Economic Policy?

2.7 SUMMARY

The economic factors such as economic planning, industry, national income, rate of economic growth, population have considerable bearing on the business. The outcome of several economic planning policies had made a note of the impact of new economic policy on the free flow of foreign capital, technology, professional and consequent influence on Indian businesses was discussed in this Unit. Finally the second generation reforms areas have been dealt in.

2.8 SELF-ASSESSMENT TEST

1. What is economic environment? How is it important for business?
2. Describe the economic environment as it prevails today in our country.
3. Why is economic planning necessary? What has been our experience with planning?
4. Bring out the salient features of the basic economic system.

2.9 FURTHER READINGS

1. Bimal Jalan, India's Economic Crisis - The Way Ahead
2. Vijay L. Kelkar and V.V. Bhanaji Rao, Indian Development Policy Imperatives, New Delhi. TMH 1996.
3. Indian Development Report 1999, 2000.

UNIT - 3 : POLITICAL AND LEGAL ENVIRONMENT

Objectives :

After going through this unit, you should be able to:

- Understand the influence of political-legal environment on business
- Know the three institutions viz., 1) Legislative; 2) Executive; and 3) Judiciary
- Get an idea of business responsibilities to Government and Vice-versa
- Learn about Judicial Activism
- Know briefly the Constitution of India
- Differentiate between the Fundamental Rights and Directive Principles of State Policy
- Know the need for re-writing our Constitution.

Structure

- 3.1 Introduction
- 3.2 Political Stability and Change
- 3.3 Three Institutions
- 3.4 Judicial Activism
- 3.5 Constitution of India
- 3.6 The Preamble
- 3.7 The Fundamental Rights
- 3.8 Directive Principles of State Policy
- 3.9 Time for Change
- 3.10 Summary
- 3.11 Self-Assessment Test
- 3.12 Further Readings

3.1 INTRODUCTION

The influence of political environment on business, is enormous. The political system prevailing in country decides, promotes, fosters, encourages, shelters, directs and controls the business activities of that country. A political system which is stable, honest, efficient and dynamic and which ensures political participation of the people, and assures personal security to the citizens, is a primary factor for economic development. The rich countries of today ascribed their success mainly to the political systems they richly enjoyed. 'There is today' comments John Kenneth Galbraith, 'no country with a stable and honest Government which does not have or has not had a reasonably satisfactory state of economic progress.' He further argues that 'In all these countries the early emphasis was not on capital investment but on political and then on cultural development. In the United States, Western Europe, and more recently in Japan, a secure political context was stressed through the first and foremost on economic development; it was considered the first step towards progress.'

Two basic political philosophies are in existence all over the world, viz., democracy and totalitarianism. In its pure sense, democracy refers to a political arrangement in which supreme power is vested in the people. Democracy may manifest itself in any of the two fundamental manners. If each individual is given the right to rule and vote on every matter, the result is pure democracy which is not, however, workable in a complex society with a large constituency. Hence, the republican form of organisation follows whereby the public, in a democratic manner, elect their representatives who do the ruling.

In totalitarianism, also called authoritarianism, individual freedom is completely subordinated to the power of authority of the State and concentrated in the hands of one person or in a small group which is not constitutionally accountable to the people. Societies ruled by a pressure clique - political, economic or military - or by a dictator, plus most oligarchies and monarchies belong to this category. The doctrines of fascism and erstwhile Russian communism are examples of totalitarianism.

During the First and Second World Wars, authoritarian governments began to appear in most mature economies. Even after the Second World War, the totalitarian system became most common in newly independent nations. Administrative efficiency of the dictators was cited as an advantage for coping with the problems of new-born States. Surprisingly, nearly two-thirds of the nations are ruled by dictators or monarchies even today.

As between democracy and totalitarianism, which political doctrine is ideal for business is a relevant question. The choice is apparently difficult because there are countries that represent the two political philosophies and both have achieved tremendous economic prosperity. America is a super power and it has achieved its position under democratic dispensation.

Similarly, former USSR attained its once super-power status but under communism. Economic development demands a political system which guarantees stability, dynamism, purposefulness, security to citizens and the involvement of people in developmental activities. Authoritarianism, no doubt, ensures stability but may fail in other respects. Democracy, in contrast, guarantees peoples' participation. The right leader being elected, democracy also can ensure stability, security, dynamism and purposefulness.

3.2 POLITICAL STABILITY AND CHANGE

There is a close nexus between political stability and business growth. There is evidence to state that business grows in a region which is politically stable. Political uncertainty is the main reason for the fall of business investment and ultimately the economic growth in Countries like Afghanistan, Bangladesh, Hongkong, Kuwait, Nigeria, the Philippines, Poland, South Africa, United Arab Emirates etc.

Even in our country political instability resulted decline in business investment from time to time. Again within the country business prospered wherever and whenever there is political stability.

Political stability of a country is to be considered not only in terms of physical events happenings but also in terms of the stability of Government machinery and policies in relation to business. Government formulates and executes a number of policies and programmes. Government frequently changes its industrial policy, fiscal policy, monetary policy, or trade and the like, it unnerves the business sector and thereby adversely affects business investment and related activities; otherwise it faces a tremendous amount of what is called non-investment and uncertainty.

Stable policies build up business confidence and help corporate planning. Further, whenever a country becomes politically stable, there would be inflow of foreign capital making heavy investments. Since 1991 many multinational companies have been in our Country and this is mainly due to change in the ideology of the Government and political stability. On the other hand, foreign enterprises in the recent past have started rethinking on the investment in India due to political uncertainties and problems (Eg. Enron's power project, KFC retail outlet etc.,).

Activity - A

What is the nexus between political environment and business?

Activity - B

In your opinion "As Between democracy and totalitarianism which political philosophy is ideal for business"?

Activity - C

Does the relationship between politicians and business will make the business or mar the same? Please express your view points.

3.3 THREE INSTITUTIONS

The political system under democratic dispensation, like ours, comprises three vital institutions, viz., legislature, executive or government and judiciary.

LEGISLATURE

Of the three, the Legislature is the most powerful political institution vested with such powers as policy making, law-making, budget approving, executive control and acting as a mirror of public opinion.

The influence of the Legislature on business is considerable. It decides such vital aspects as the type of business activities the country should have, who should own them, what should be their size of operations, what should happen to their earnings and other related factors.

EXECUTIVE OR GOVERNMENT

Also called the 'state', the term Government refers to '..... the centre of political authority having the power to govern those it serves.' More or less a similar meaning is given by E.V. Schneider when he described government as 'that institution by which men everywhere seek to order society, that is, to control the structure and functioning of society.'

The founders of our Constitution provided for a federal set-up, with powers being divided between the national and the state governments. The powers and functions of the central and state governments are described in the Constitution. The emphasis throughout this section is on the role of national or central government in sharing, directing and controlling the business activities.

What are government's responsibilities to business? What are responsibilities of business houses to the government? Following paragraphs answer these questions.

Business Responsibilities to Government :

Business firms have a number of responsibilities to the government. Business firms must obey the laws of central, state and local governments. Such laws and regulations may pervade the entire gamut of a business enterprise. Business must go beyond obeying laws and regulations. It should look to the government for support, sustenance, encouragement and guidance. Business leaders must look upon government as a big brother who is wiser, more matured, more mellowed and less impetuous element in business. Business must also play a vital role in helping the government to develop its functioning capabilities. A few important responsibilities of business towards the government are explained below :

(a) **Tax Payment :** Taxes paid by business enterprises constitute a major source of revenue to the government. Firms themselves pay regular taxes on their sales, inputs and income and also deduct, at source, income taxes from salaries and wages of employees and remit the collections to the government.

(b) **Voluntary Programmes :** Business firms cooperate with government agencies on a voluntary basis in connection with various programmes such as withholdings stated amounts from wages and salaries of employees for the purchase of National Savings Certificates, or giving special assistance to local governmental units in connection with drought relief, education, tree planting, sanitary works or recreational activities. In cooperation with the government, business firms train the unemployed and support non-discriminative recruitment of personnel and workmen. Business extends these facilities under the name of social responsibility.

(c) **Providing Information :** Political leaders, either because of inexperience or over enthusiasm, make certain decisions which may not be in the overall interest of business. The onus then lies with business leaders to place before the decision-makers the facts and problems, individually or through forums, and argue for the modification or change of decisions. Business leaders possess the necessary knowledge and experience to place their points of view before the political leaders.

(d) **Government Contracts :** Many business firms bid for government contracts and, if successful, carry out the resulting projects with the required specifications and standards. Housing projects, oil pipelines, turnkey projects and others are executed by private business houses for the government.

(e) **Government Service :** Business offers services of its leaders to the government. It is not unusual for business executives to lead or accompany delegations to foreign countries for exploring trade and industry prospects. Similarly, business leaders serve on various advisory boards constituted by the government.

(f) Political Activity : Political participation is a much debated subject today. There are arguments for and against participation of business in political activities. Justifying business-politics nexus G.D. Birla once said, "As the Bhagavad Gita says, every man must do his duty - which means if you are a wealthy man, you must do your duty by your wealth, and his dharma is to provide for general welfare. If political action is involved in this, I don't see why I should fight shy of it. Edwin M. Epstein also support corporate involvement in politics. Involvement enhances the quality of pluralism and provides an additional safeguard against the authoritarian potential of a mass society.

Opposition to business involvement in politics is equally strong. J.R.D. Tata once wrote: "I have never regretted my decision to stay out of politics which I rationalised to myself by concluding that I could do more for my country in business and industry than in politics for which all my instincts in any case made me unfit". More powerful argument came from Arnold Maremont. Stated he : "It is my conviction that business ought, for its own good, to stay out of politics. I favour the widest possible participation in politics on an individual basis, for when it becomes the province of the elite few, our systems are in danger. It is when corporations begin running political classes, conducting political schools, and urging that their executives enter the political arena to expound the corporation's viewpoint that I become deeply fearful of the consequences".

Different viewpoints apart, business has been involved in political activities since long. Contrary to protestations of J.R.D. Tata, the Tatas did support political activities. They financed a number of organisations in Mumbai that are critical of what they call the Soviet model of development. They were also closely connected with the establishment of Swatantra Party in the 1960s. Birlas do much more. They run newspapers, finance political candidates and parties and even contest elections on their own. In fact, they have always played an active role in politics, and did so even before Independence, when it was much more hazardous to do so. Instances of this type are many. Nexus between business and politics is therefore, an established fact.

What are the ways of involvement is the next logical question. One way is to make monetary contributions to political parties, particularly at the time of elections. Corporate contributions to political parties have now been legalised in our country, merits and demerits notwithstanding. The other way of participation is for business leaders to contest elections as independents or on party labels. The third way of involvement is through lobbying which refer to behaviour after the elections and is concerned with securing legislation in the favour of business.

Government Responsibilities to Business :

Government responsibilities to business are much greater than the obligations of business to the government. Government has the power, will and resources to decide, shape, guide and control business activities. Being democratically elected and having accepted the mixed economy, our government is clear about the role it has to play and the responsibilities it has to discharge towards business houses. As promoter and regulator of business activities, the government has been discharging its obligations quite effectively, failures notwithstanding. Specifically, the government's responsibilities towards business are as follows:

Establishment and Enforcement of Laws :

Government establishes and enforces laws and regulations under which the business functions. Laws and regulations covering all aspects of business are enacted by the government. Government is responsible for providing the 'rules of the game', which make the business systems function smoothly and which help maintain competition, or if monopolies develop, to regulate them or supplement them by government operations. It is the responsibility to government

to enforce the laws and to provide a system of courts for adjudicating differences between business firms, individuals, or government agencies.

Maintenance of Order :

Government has the responsibility of maintaining order and protecting persons and property. It would be impossible to carry on business in the absence of a peaceful atmosphere.

This is borne out by the decline in the number of industrial licences issued to Punjab during 1986. The total number of licences issued during 1986 was 618. Of these, Punjab accounted for only 37 as against 94 the state has bagged in 1984. "This is perhaps" remarks Economics Times of March 14, 1987, "due to the disturbed conditions prevalent in the state".

Money and Credit :

The government provides a system of money and credit by means of which transactions can be affected. It is also the responsibility of the government to regulate money and credit and protect the integrity of the rupee, that is, to guard against rapid fall in its value.

Orderly Growth :

Orderly growth implies balanced regional development, distributive justice, full employment and protecting the economy against 'booms and busts'. The Government has the resources and capabilities to ensure orderly growth.

Infrastructure :

Business needs for its effective functioning such infrastructural facilities as transportation, power, finance, trained personnel and civic amenities. It is the responsibility of the government to provide these facilities.

Information :

Government agencies publish and provide a large volume of information which is used extensively by business firms. Included are information services of the departments of commerce and industry, agriculture, labour, health, education, banking, atomic energy and host of others. These services carry on important activities in providing business firms and private citizens with objective and impartial information about economic and business activity in general, specific lines of business, scientific and technological developments and many other things of interest to business leaders.

Many state and local governments also provide information highly useful for business leaders in conducting their activities.

Assistance to Small Industries :

Small-size business establishments have special role to play in our economy. Being small in size, these firms face problems relating to finance, marketing, know-how and do-how and infrastructural facilities. It is again the responsibility of the government to provide the required facilities and encourage the small-scale sectors to grow.

Transfer of Technology :

Government-owned research establishments transfer their discoveries to the private industry in order to put them to commercial production. The Indian Space Research Organisation (ISRO), a Central Government undertaking, has successfully spun off more than 130 products/processes from its labs to the Indian industry in the last decade. Of these, 110 are in active production. More striking success in the technology transfers is in the area of instruments for processing remote sensing data.

Government Competition :

Government often competes with private business firms for the purpose of regulating competition, improving quality, or to supplement private activities with government programmes. In some cases, the government regulates the prices which may be charged for buyers.

Inspections and Licences :

Government agencies conduct inspection activities—foods and drugs, for example, assuring quality products to consumers. Government issues licences to competent business establishments to carry on different activities.

Tariffs and Quotas :

Tariffs and quotas are used by the government to protect business from foreign competition. One of the problems faced by exporting countries all around, particularly Japan, is the protectionist policies adopted by developed countries. Similarly, incentives and subsidies are granted by the government to encourage the development of home industries.

For many, the above obligations of the government may look irrelevant because of reforms introduced by the government in the recent past. While it is true that the reforms have resulted in the diminished role of the government, the role per se has not been abolished. Thus, industrial licensing continues though the list of industries subject to licensing has been pruned. Similarly, tariffs and quotas do exist though on a less scale.

JUDICIARY

The third political institution is the Judiciary. Judiciary determines the manner in which the work of the Executive has been fulfilled. It sees to it that the exercise of executive authority conforms to the general rules laid down by the legislature, it may declare that the particular order issued is, in fact, **ultra vires**. It also settles the relationship between private citizens, on the one hand, and between citizens and the government upon the other, where these give rise to problems which do not admit of solution by the government.

The powers of the judiciary are of the dual type:

- (i) The authority of the courts to settle legal disputes; and
- (ii) Judicial review—the authority of the courts to rule on the constitutionality of legislation.

As far as the second is concerned, the Judiciary gets activated when the legislature passes laws which are repugnant to the Constitution and when executive implements the enactment approved by the legislature in a manner opposed to the requirements of the legislation.

In other words, the courts of justice protect the citizens from unlawful acts passed by the legislature and arbitrary acts done by the Executive.

It is the power of the judiciary to settle legal disputes that affects business considerably. Disputes between employer and employee; employer and employees, employee and employee, employer and public and employer and the government are often referred to courts for settlement and their verdicts are sought.

The judicial pronouncements will have far-reaching consequences on business. The consequences will become more intense and severe because (i) judicial errors do occur, though infrequent; (ii) possibility of wrong assessment of penalty. Judges notoriously vary in the severity of punishment inflicted, (iii) judges are known for pronouncing conflicting verdicts on the same or similar disputes and (iv) there is a lot of confusion in labour laws themselves.

Particularly in the area of industrial relations, the role of judiciary has been more pronounced and unfortunately regressive. During the last decade and a half, in the name of 'Directive Principles', 'Social Justice', and 'activist law making', the Supreme Court, instead of having a balanced and reserved consideration of opposing interests, has entirely vitiated the industrial relations fabric by making wholesale dogmatic assertions in undermining discipline. To borrow a simile from G.K. Chesterton, while dealing with discipline cases, the Court lost not only the path but also the map and the compass. It has gone to the extent to say that even an "illegal strike is justified. By those whose horizons are limited, trifles are easily confused with technicalities. The result is that indiscipline in industry has spread like wildfire and sapped the national production and productivity. The classic case is the textile industry which has been wrecked by indiscipline. The conflagration is continuing to engulf various industries one by one.

The problem is more compounded because the judiciary itself has landed in an unevitable pass. "Today, litigative justice has come to a grinding halt", wrote Justice V.R. Krishna Iyer, the judiciary has caricatured itself into a dinosaur and both the Bench and the Bar, alas, have become a law unto themselves, Indian humanity having come to discard the judiciary as barred by limitation of item except as a pantomime. If it is not to be regarded as a case of survival after death, a new clan is needed now. The cult of the robed process has short mileage! If all the judges and lawyers of India pull down the shutters of their law shops nationwide, injustice may not any more escalate. If at all, litigative waste of human and material resources may be obviated. What an obituary!

"Many superficial diagnosis, charlatan recipes and myopic prognosis have been offered which are as potent therapeutically as painkillers for terminal cancer. Esoteric jurists have interpreted the decadent judicial disorder in various ways. Our statesmanly task is to transform this imbroglio into an opportunity for overhaul which by performance, restores order and confidence not only in the lowly, the lost and the last. Business management must come to court! I am convinced that democracy will die soon if an independent, alert and quick-to-act judiciary-not a functioning anarchy-does not come alive as a sentinel on the *qui vive*!"

Activity - D

How effectively co-ordination can be maintained among the three institutions without tinkering one organ with the other?

Activity - E

Write a brief note on contributions to 'Political Fund' by businessmen with examples.

Activity - F

In what way the Government policies affect the business houses? Explain briefly.

Activity - G

Has judiciary really been playing the role of watch-dog? Give reasons.

3.4 JUDICIAL ACTIVISM

Judicial activism is very much in the news in our country these days. This is so because the gentlemen wearing grey robes started moving out of their ivory towers and began interfering in areas which, it was thought, were not theirs.

Consider the following :

Judiciary punishes officials and demoralises bureaucracy; pulls up and injects the Election Commission; monitors the quantum of rainfall and irrigation waters; checks and regulates admissions to professional colleges by issuing memoranda on capital deregulation; orders the closure of fume-emitting factories and measures up pollution levels; calls up data on deforestation; decrees CBI enquiry into scandals, crimes and custodial deaths; enquires into temple administrators; grants promotions as well as increments to officials; restrains and censures human rights violations and so forth. Common man understands this activist role as **judicial activism**.

In its real sense, judicial activism refers to the review power vested with the courts and its scope varies with the width of power conferred on courts. The scope is wider where the power of judicial review extends not only over executive action, as in the UK; but also over legislative action, as in the US and even over constitutional amendments as in India.

The term judicial activism was first used in the USA. It was in 1954 that the US Supreme Court, in the historic *Brown Vs Board of Education* case, declared that separate, segregated schools for blacks and whites were unconstitutional. The Court did something which Congress and the President feared to do because of the dangerous political fall-outs it would produce.

In our country, judicial activism is just 18 years old. It represents a sustained effort on the part of the highest judiciary to provide access to justice for the deprived sections of Indian humanity. With a legal architecture designed for a colonial administration and a jurisprudence structured around a free market economy, the Indian judiciary could not accomplish much in fulfilling the constitutional aspirations of the vast masses of underprivileged people during the first three decades of freedom. During the last 18 years, however, judicial activism has opened

up a dimension of the judiciary process, and this new dimension is a direct emulation from the basic objectives and values underlying the Indian Constitution.

There are arguments for and against judicial activism. The proponents of judicial activism argue that it is an essential part of judicial process in a democracy like ours. Judicial activism is felt necessary to ensure distributive justice, to restore faith in the people towards social and political institutions and to check declining values in our society.

Judicial activism is opposed on several counts. It is said that judicial activism gives rise to much anxiety in the executive and the legislature, especially about the continuing prospect of our over-reaching judicial entry into the traditional areas of executive power. It is also said that judicial activism leads to a government by judiciary which is not supported by any popular mandate. Further, most of the judicial review cases cause enormous financial strain on the Exchequer.

In spite of the criticisms, it may be stated that the Indian judicial review today is an area of great promise. The world of law acclaims that some of the recent steps of the apex court certainly enhanced its status.

Activity - H

“Judicial Activism is a necessary evil” - Comment

3.5 CONSTITUTION OF INDIA

The Constitution of India is the most significant document which is fundamental to the governance of the State. It has economic significance of far-reaching implications. This unit is devoted to a brief discussion of the economic provisions of the Constitution.

The Constitution of the Indian Republic is the product not of political revolution but of the research and deliberations of a body of eminent representatives of the people who sought to improve upon the then existing system.

In order to understand and appreciate the philosophy underlying the Indian Constitution, one must look back into the resolution which was passed at the Karachi session of the Indian National Congress in 1931. The Resolution stated that **“in order to end the exploitation of the masses, political freedom must include the real economic freedom of the starving millions”** The State was to safeguard **“the interest of industrial workers,”** ensuring that **“suitable legislation”** should secure them a living wage, healthy conditions, limited hours of labour, and protection from **“the economic consequences of old age, sickness and unemployment.”** The State was to **“own or control key industries and services, mineral resources, railways, waterways, shipping and other means of public transport.”**

The historic Objectives Resolution which was moved by Pandit Jawaharlal Nehru on 9 December 1946 and which was subsequently adopted by the Constituent Assembly on 22 January 1947, inspired the shaping of the Constitution through all its subsequent stages.

The Constitution has three parts, viz., the Preamble, the Fundamental Rights, and the Directive Principles of State Policy.

3.6 THE PREAMBLE

The Preamble is an introduction to the Constitution and contains its basic philosophy. The Preamble to the India Constitution states that *"We the people of India having solemnly resolved to constitute ourselves into a Sovereign, Socialist, Secular, Democratic Republic and to secure to all citizens:*

"Justice: social, economic and political;

Liberty of thought, expression, belief, faith and worship;

Equality of status and opportunity; and to promote among them all fraternity assuring the dignity of the individual and the unity and integrity of the Nation.

"In our Constituent Assembly this 26th day of November 1949 Do Hereby Adopt, Enact and give to Ourselves this Constitution".

The words - "We, the people of India...adopt, enact and give to ourselves this Constitution:, declare the ultimate sovereignty of the people of India and that the Constitution rests on their authority.

Thus, the goal envisaged by the Constitution is that of a "Welfare State" and the establishment of a socialistic pattern of society.

The Preamble recognises the truth of the proposition that political freedom is not an end by itself; it is a means to secure to all citizens social, economic and political justice. In other words, the Preamble commits India to the ideal of converting political democracy established by the Constitution into a social and economic democracy and that too in a democratic way, under the rule of law.

Certain key words in the Preamble need elaboration.

Sovereign

With the passing of the Indian Independence Act, 1947, India ceased to be a dependency of the British Empire. From 15th August, 1947, to 26th January, 1950, her political status was that of a Dominion in the British Commonwealth of Nations. But with the writing of the Constitution, India became a 'Sovereign Republic' like the United States of America or the Swiss Republic. However, India still remains a member of the Commonwealth of Nations.

This peculiar position is the result of an agreement reached at the Commonwealth Prime Ministers' Conference held in London in April 1949.

Socialist

The Word 'Socialist' was added to the Preamble by the 42nd Amendment of the Constitution in 1976. Socialism implies State ownership and management of tools of production with the benefits to insure to the public. It also advocates agrarian reforms, a strong public sector, control over private investment and wealth and national self-reliance.

Socialism does not involve the equal division of existing wealth among the people but advocates an egalitarian principle. It believes in providing employment to all employable people and emphasizes suitable rewards to the efforts put in by every worker.

The Government of India has adopted socialism as the goal of its economic and social policy which the country shall pursue. This concept is used by the ruling party in different ways

at different times. In the beginning, 'the socialist pattern of society' was emphasised. More recently, 'social justice with economic growth' is referred to. There are several political parties in the country which also proclaim socialism as their goal, though the meaning attached to the phrase by these parties is not clear. The word 'socialism', therefore, connotes different things to different parties and different individuals, and this is often reflected in the pronouncements of individual politicians as well as in the manifestoes of different political parties.

The concept of 'socialism' is vague, as no one has defined it in concrete terms. Nationalisation of industries and other economic activities are adopted as the method to usher in socialism in our country. The result is that the urge to greater production has disappeared and the availability of goods is not enough to remove poverty. It has not been realised that the effort to make the few rich poor, will not make the many poor, rich. The question is whether nationalisation or 'takeover' of existing units is not adopted in order to obtain more power and patronage to the politicians.

Secular

The word 'secular' like the word 'socialism' was inserted in the Preamble by the 42nd Amendment to the Constitution in 1976. The real spirit of secularism is to make religion purely a private affair and to manage the affairs of the State free from any religious influence. In practice, secularism is understood to mean according equal encouragement to all religions. It is here that the national leaders seem to have erred on the wrong side, and it is because of this that the minorities in our country feel unsafe and insecure.

Democratic

The term 'democratic' is comprehensive. In a narrow political sense, it refers only to the form of government, a representative and responsible system under which those who administer the affairs of the State are chosen by the electorate and accountable to them. But, in its broadest sense, it embraces, in addition to political democracy, also social and economic democracy. The term 'democratic' is used in this sense in the Preamble.

Republic

The term 'republic' implies an elected Head of State. A democratic state may have an elected or hereditary head. Britain is the best example of the latter type, where the monarch, the hereditary head, is not an hindrance to the democratic government as the real power of the State is in the hands of the elected representatives. Under the republican form of government, on the other hand, the head of State is always elected for a fixed term. Ours is a republican form and for every five-year period, we elect our President who is the head of State.

The Preamble proceeds further to define the objective of the Indian Republic. These objectives are four in number: justice, liberty, equality, and fraternity. Justice implies a harmonious reconciliation of individual conduct with the general welfare of society. The essence of justice is the attainment of the common good. It embraces, as the Preamble proclaims, the entire social, economic and political spheres of human activity.

Liberty

The term "liberty" signifies the absence of any arbitrary restraint on the freedom of individual action and the creation of conditions conducive to the fullest development of the personality of the individual. Since society is composed of individuals, social progress depends on the development of the individual. Hence, it is in the interest of society to ensure the maximum liberty of thought and action of the individual, commensurate with the social conditions and circumstance.

Liberty and equality are complementary. Equality does not mean that all human beings are equal, mentally and physically. It signifies equality of status, the status of free individuals; and equality of opportunity. Equality of opportunity implies the availability of opportunity to everyone to develop his or her potential capacities.

Fraternity

The term "fraternity" implies the spirit of brotherhood. In a country like India with many disruptive social forces, communal and caste, sectional and denominational, local and regional, linguistic and cultural, the unity of the nation can be preserved only through a spirit of brotherhood that pervades the entire country, among all its citizens, irrespective of their differences. Through the establishment of a new nation based upon justice, liberty and equality, all must feel that they are the children of the same soil, of the same motherland and members of the same fraternity.

The key words and the objectives mentioned in the Preamble have great economic significance. They indicate the need and scope of State intervention in economic activities.

The Preamble does not have any legal value, yet in cases of doubt, the Supreme Court often refers to the Preamble to elucidate some of the vague provisions of the Constitution. The real value of the Preamble lies in its psychological appeal to the citizens through words surcharged with emotion—justice, liberty, equality and fraternity. As justice Hidayatulla has rightly said, "The Preamble is more than a mere declaration. It is the soul of our Constitution and lays down the pattern of our political society. It contains a solemn resolve which nothing but a revolution can alter."

Activity - I

Whether 'Right to Work' be made as a fundamental right or not? Express your feelings.

3.7 THE FUNDAMENTAL RIGHTS

The Constitution has eight Fundamental Rights as mentioned below :

1. Right to equality
2. Right to six freedoms, viz.,
 - (a) Freedom of speech and expression;
 - (b) Freedom to assemble peacefully and without arms;
 - (c) Freedom to form associations or unions;
 - (d) Freedom to move freely throughout the territory of India;
 - (e) Freedom to reside and settle in any part of the territory of India; and
 - (f) Freedom to practise any profession or to carry on any occupation, trade or business.
3. Right to life and personal property;
4. Right to freedom of religion;
5. Right to cultural and educational freedom;

6. Right against exploitation;
7. Right to private propriety; and
8. Right to Constitutional remedies.

The right to property has been repealed with effect from June 20, 1979.

Some of the Fundamental Rights have economic significance. The right to equality, for example, prohibits discrimination against any citizen on grounds of religion, race, caste, sex or place of birth. Implied in the right to equality is the concept of protective discrimination which assures protection to Scheduled Castes who have suffered discrimination for centuries. Special efforts are to be made for the development of the socially and economically backward sections of society.

Right to freedom is an important and the most valuable fundamental right guaranteed by the Constitution. As Nani Palkhivala has said, "*The Constitution is a part of the great heritage of every Indian. Its founding fathers wanted to ensure that even while India remained poor in per capita income, it should be rich in individual freedom.*"

Particularly, the right to practise any profession or to carry on any occupation, trade or business has great economic significance. The Constitution guarantees to citizens the fundamental right of freedom to take up any job or carry on any trade or business. The freedom of profession is however, exceptional in three cases, viz., (a) public interest, (b) requiring technical or professional qualifications, and (c) when a State itself decides to engage in any trade or occupation, the individual freedom is restricted.

The fundamental right against exploitation prohibits the exploitation of the weaker sections of society by individuals as well as by the State. Article 23 prohibits traffic in human beings and forced labour. Article 23 reads thus: "**Traffic in human beings and other similar forms of forced labour are prohibited and any contravention of this provision shall be an offense punishable in accordance with the law.**" Article 24 provides special protection to children. It reads thus: "**No child below the age of fourteen years shall be employed to work in any factory, mine or engaged in any other hazardous employment.**"

Thus, the fundamental rights enshrined in the Constitution guarantee several economic rights to the citizens. At the same time, the State is empowered to impose reasonable restrictions on such economic rights in public interest. It is this power that has enabled the government to impose a series of statutory controls over business.

3.8 DIRECTIVE PRINCIPLES OF STATE POLICY

The Directive Principles of State Policy are a unique feature of our Constitution. Speaking on the Directive Principles, Dr. Ambedkar observed: "The Directive Principles are like the instruments of instructions which were issued to the Governor-General and the Governors of colonies, and to those of India by the British Government under the 1935 Government of India Act. What is called 'Directive Principles' is merely another name for the instruments of instructions. The only difference is that they are instructions to the legislature and the executive. Whoever captures power will not be free to do what he likes with it. In the exercise of it, he will have to respect these Instruments of Instructions which are called Directive Principles. He cannot ignore them."

The Directive Principles are the directives to the various governments and government agencies and are fundamental in the governance of the country. As Pylee observed, "The Directive Principles enshrine the fundamentals for the realisation of which the State in India stands. They guide the path which will lead the people of India to achieve the noble ideals which

the Preamble of the Constitution proclaims : Justice-social, economic and political, liberty, equality and fraternity.”

The Directive Principles may be classified, for convenience, under four heads as shown below:

1. Provisions dealing with Welfare (Art. 38, 42, 45, 47)
2. Provisions dealing with Social Justice (Art. 39, 41, 43, 46)
3. Provisions promoting Democracy (Art. 40, 44, 45).
4. Miscellaneous Provisions (Art. 48, 50, 51).

The first two categories of provisions have economic significance.

Article 38(1) lays down that the State shall promote the welfare of the people by securing a social order in which justice - social, economic and political - shall inform all the institutions of national life. Justice and welfare are the twin objectives of our Constitution.

Article 38(2) lays down that the State shall strive to minimise the inequalities in income, and eliminate inequalities in status, facilities, and opportunities, not only among individuals but also among groups of people.

Article 39 emphasises that the State shall direct its policy towards securing : (a) adequate means of livelihood to all citizens; (b) a proper distribution of the material resources of the community to the common good; (c) the prevention of concentration of wealth to the common detriment; (d) equal pay for equal work for both men and women; (e) the protection of the strength and health of workers and avoiding circumstances which force citizens to enter avocations unsuited to their age or strength; and (f) the protection of childhood and youth against exploitation or moral and material abandonment.

Article 41 lays down that the State shall, within the limits of its economic capacity and development, make provision for securing the right to work, to education and to public assistance in cases of unemployment, old age, sickness and disablement.

Article 42 lays down that the State shall make provision for securing just and humane conditions of work and for maternity relief.

Article 43 emphasises the necessity of an adequate or living wage in all sectors of economic activity. The Article enjoins that healthy conditions of work should be provided and a decent standard of living should be guaranteed. It also stresses the right to leisure for all working people. The cottage industries in rural areas should be promoted either through individual or cooperative efforts.

Article 43(A) states that the State shall take steps to secure the participation of workers in the management of undertakings, establishments or other organisations engaged in any industry.

The State shall promote, with special care, the educational and economic interest of the weaker sections of the people, and in particular, of the Scheduled Castes, Scheduled Tribes and shall protect them from social injustice and all forms of exploitation (Article 46).

The State shall endeavour to protect and improve the environment and to safeguard the forests and wildlife of the country (Article 48(A)).

Thus, the Directive Principles of State Policy enjoin upon the State varied responsibilities and provide vast scope for State intervention in the economy.

Activity -J

In spite of Constitutional and Supreme Court's embargo on child labour, day-by-day the influx on children to the labour force is accelerating. Suggest measures to curtail the same.

3.9 TIME FOR CHANGE

For more than four decades, the Constitution has been guiding the destiny of our country. It is said that the Constitution has put several roadblocks which check the pace of the country's economic development, roadblocks manifesting through sporadic communal clashes, moral disintegration, growing regional and parochial tendencies, corrupt bureaucracy, umpteen regulatory legislations and their implementing agencies, and topping all, the helplessness of the government in attacking the roots of the menacing problems.

Partly, the problem lies with the background against which the Constitution was drafted and adopted. "It is of importance", wrote B.K. Nehru, "that we should remember how the Constituent Assembly was composed. The electorate was confined to a fraction of the total adult population, the qualifications for the vote being property, education and the payment of tax. The mass of the people, the great have-nots, were totally unrepresented on the body that framed the system which still governs us. Virtually, all the members of the Constituent Assembly were men of reasonable affluence and education. They were primarily concerned not with economic problems or hunger of the people but with the absence of civil liberties, particularly those liberties such as freedom of speech or of association, which had been lacking in British India and whose absence they had keenly felt. This is the explanation for the great stress in the Constitution on the Fundamental Rights of the individuals as practised in Western democratic society and the elaborate safeguards for their preservation.

"Further more, the Constituent Assembly was dominated by lawyers, trained solely in the British tradition and in the British system of law, who constituted a substantial proportion of membership of the Assembly. Their knowledge of constitutional law was largely confined within the horizon of the British constitution. That, like all British institutions and all British customs, no matter how unsuitable for our country, had been held up to us as a perfect model to be emulated by subject societies.

"...We should recognise that the Indian Constitution... is not helping the country to attain the goals it was meant to achieve. It is not use saying that the Constitution is perfect but it is the men who have failed."

Further, the founding fathers failed to visualise the society and polity that would emerge in the decades to follow. The freedom movement was fought in a different milieu. The objective before the masses was clear and divisive factors like caste and religion were not a constraint. People from all walks of life forgot their differences and fought shoulder-to-shoulder with one aim in mind-freedom at any cost.

But their behaviour, particularly of the leaders, once freedom was acquired could not be predicted. The resumption that people will continue to be motivated by the same fire proved

wrong. The dream of a prosperous and free society did not come true. The consequence : The country in 1996 is entirely different from what it was in 1947. Naturally, the Constitution of the early years cannot be relevant for 1990s.

The founding fathers gave greater role to State with an objective of ushering socialism in the country. But socialism has not been realised. On the other hand, it is capitalism which has been promoted.

The various reform measures which the State took in the following years strengthened capitalism, and not socialism. The impact of planned economic development of the country resulted in the emergence of capitalism in agriculture in selected areas, while it has also accelerated the growth of the manufacturing sector in the industry and the national market in India. Beside, a few more facts may be mentioned to understand the role of the State in building capitalism in India.

- (a) The State is the chief mobilizer of resources and saving in the country for investment. Public-controlled institutions like the development banks and the nationalised commercial banks, have centralised resources in the hands of the State to be invested in the State capitalist sector and the private corporate sector.
- (b) The State has actively supported science and technology and Research and Development efforts for building capitalism.
- (c) The State has the responsibility to develop infrastructure like power, transport and irrigation for the development of capitalism.
- (d) During the last forty years, the State has consciously developed and is trying to strengthen private property by encouraging small-scale and medium industries, and at the apex, it has harmonised the interests of big business, political leaders and public bureaucracy, who have common stakes in capitalism as investors and profit-seekers.

Thus, despite socialistic pretensions, the State and the political parties, never accepted the philosophy of 'welfarism' either in economy or in polity.

India has come a long way since 1950 when the centralised planning system was adopted for economic development. For a full forty years, the entire life, economic and political, was conditioned by a system in which everything was controlled by the government, which in reality meant, the politician. With the passage of time, the government became personified in an individual. The functioning of the government became such that development became sluggish and the country was out of alignment with global trends. Even when the Soviet system and the eastern European block was crumbling and was changing to the new world order, the Indian system remained rigid. Whatever little changes were made were either not implemented or implemented half-heartedly.

From 1991 onwards, there has been a restructuring of the economy from the command to a market oriented one. Now the changes in the economic system have to be incorporated in the political system also, if a new order is to be established in the country. This necessitates a change in the Indian Constitution.

Required Changes :

A relevant question here is : What should the Constitution look like? In fact, a Constitution should give clear directions to the polity and the economy. The US Constitution directs the State to form a society based on freedom, liberty and general welfare. The social, political and economic development during the last two centuries has brought a system based on free market economy.

The British Constitution which, over the last few centuries, developed along with British thinking, is based on the rule of law. The entire edifice of the British polity and economy is based on this concept. The Indian Constitution has no direction in the beginning. But the rulers wanted to establish a socialist society. Since we have decided to say goodbye to it, the Constitution should be modified keeping in view the requirements of the changed economy.

The first need is to change the Preamble. The Preamble, as was pointed out earlier, determines the general purpose behind a Constitution and is never regarded as a source of power. Since the Preamble is meant to explain certain facts which are necessary to be explained before the enactments contained in the Act can be understood, it should not have too many such concepts. The original Preamble did not have too many confusing concepts. The original Preamble did not contain the words 'socialist, secular'. Moreover, the condition of the economy and the relationship between various religious communities have deteriorated since these two words were inserted by the Constitution (42nd) Amendment Act of 1976 by a Parliament whose credibility was doubtful. Juxtaposing it with the recent metamorphosis in the government policy, it is time to restore the original position of 1950 and declare India as only 'Sovereign Democratic Republic'.

The second change needed is to remove the Directive Principles. Directive Principles are not legally enforceable in the courts and the State cannot be held responsible for not formulating public policies in conformity with the Directive Principles.

Almost all the Directive Principles, like equal right to an adequate means of living, distribution to subserve the common good, checking concentration of economic power, equal pay for equal work and stopping entry to hazardous vocations are vague and confused. However, most of the developed countries have adopted these principles in their system by enacting legislations and strictly enforcing them.

The third need is to restore the right to property which was guaranteed by Article 31 of the Constitution. The 44th Amendment Act of 1978 again by a superannuated Parliament, omitted Article 31. Now, the legislature is free to take away a person's property without payment of any compensation. The person has no remedy before a court of law and the courts cannot challenge the validity of such a law. The need of the changing times is to restore Article 31. Whether or not these and other related issues will be taken up by the recently constituted panel to review Constitution, is to be seen.

Business Laws in India :

Thus the legal environment is an important off-shoot of political environment but it reflects long-term objectives of the public and the political leadership chosen by it. Thus, influenced by its own ideology and popular pressure the Government may enact laws to regulate and control business activities and any violation of these laws may invite severe penalties and punishment for the offenders. Important among the laws within the framework of which a business is required to operate in India are:

1. Contract Act, 1873
2. Companies Act., 1956
3. Factories Act, 1948
4. Industrial Disputes Act, 1947
5. Workmen Compensation Act, 1928
6. Essential Commodities Act, 1948
7. Industries (Development and Regulation) Act, 1951

8. MRTP Act, 1971

9. FEMA, 1999

10. Consumer Protection Act, 1986

11. Income Tax Act, 1961, and various other tax laws relating to direct and indirect taxes.

Activity - K

How many articles and schedules are there in our Constitution as on date?

Activity - L

- 1) Visit some of the leading lawyers in your area and discuss with them the role of judiciary in
 - a) The businesses
 - b) Activating the legislature and executive
- 2) Visit some of the Judges of District and High Court and Interact with them about
 - (i) Tax matters (ii) Child-Labour abolition (iii) Constitution Revision.

Activity - M

The constitution of Constitution Review Committee had evoked hue and cry across the nation. Do you think, it should be reviewed and re-written in the present context? Give your reasons.

3.10 SUMMARY

In this unit, an attempt has been made to identify the linkages of political environment with business enterprise. The three vital institutions, namely legislature, executive or government and judiciary influence on business has been discussed widely. The responsibilities of business to government and vice-versa were also highlighted. Further the gist of judicial activism in our country, Constitution of India and important concepts were studied. The difference between the Fundamental Rights and Directive Principles of State Policy has been clearly analysed. It has also been noted that the time was ripe to review the Constitution.

3.11 SELF - ASSESSMENT TEST

1. Bring out the points for and against continued State intervention in business.
 2. "As on today there is no country in the world where overnment of the land does not interfere in its economic activities". Do you agree? Discuss
 3. Constitution has put several road blocks which have checked the pace of the country's economic development" - Elucidate
 4. Discuss the impact of (a) Legislative (b) Executive and (c) Judiciary on business.
-

3.12 FURTHER READINGS

1. John Kenneth Galbriath, Essays from the Poor to the Rich
2. P.N. Bhagavati, Judicial Activism and Public Interest Litigation, Dharwad, Jagrut Bharat, 1983.
3. Nani Palkhivala, We the People
4. SS Khera, Government in Business
5. World Development Report, 2000.

BRAOU

UNIT - 4 : TECHNOLOGICAL ENVIRONMENT

Objectives

After studying this unit, you should be able to :

- Understand the meaning of the terms "Technology", "Science", 'Gray plague', TQM, BPRE, and FMS
- Know the impact of Technology under three heads :
 - (a) Technology and Social Change;
 - (b) Economic effects of technology; and
 - (c) Technology and plant level changes.

Structure

- 4.1 Introduction
- 4.2 Impact of Technology
 - 4.2.1 Technology and Society
 - 4.2.2 Technology and Economy
 - 4.2.3 Plant Level Implications
- 4.3 Summary
- 4.4 Self-Assessment Test
- 4.5 Further Readings

4.1 INTRODUCTION

Among all the segments of macro-environment, technological environment exerts considerable influence on business. This section is devoted to a detailed discussion of the interface between business and technology.

J.K. Galbraith define technology as a 'systematic application of scientific or other organised knowledge to practical tasks'. During the last 150 years, technology has developed substantially. Science and technology enabled man to conquer distances; control birth rate; save lives; generate, preserve and distribute energy; discover new materials and substitutes to existing ones; introduce machines to do the work of human beings; substitute mental work with computers; probe deep into the seas and space in search of new treasures; provide himself with lot of leisure and comfort ad infinitum.

As years roll by, new discoveries have been added. 1983 was particularly considered by scientists as the year of scientific success. In this year, scientists put a billion dollar technology into space; produced the world's first test-tube triplets and obtained evidence of another solar system. In the field of medicine, Japan marketed the much-awaited artificial blood system. A major breakthrough was achieved in the field of genetic engineering to cure dwarfism. The US physicists stripped off all the electrons from the uranium atom thus exposing the bare nucleus. It was also the year when the doctors were confronted with a baffling disease, viz., AIDS (Acquired Immune Deficiency Syndrome) also named 'Gray Plague' that has taken a heavy toll of human lives.

Technology is the most dramatic force shaping the destiny of people all over the world. Some of the technological inventions the man feels, are wonders, some others are horrors, and yet others have mixed blessings. Automobiles and television, for example, have evoked mixed reactions. Hydrogen bomb, nerve gas and sub-marine guns have proved to be horrors. Penicillin, open heart surgery and birth control pills are wonders.

Whether one is enthralled or appalled by a technological invention depends on one's attitude towards it.

Activity A

1. List the changes in the life style of people in our county owing to technological advancement.

2. Who invented "Computer"?

3. What CTBT stand for?

4. Is our country a Nuclear State? Give reasons.

4.2 IMPACT OF TECHNOLOGY

We propose to discuss the impact of technology under three heads (a) technology and social change, (b) economic effects of technology, and (c) technology and plant level changes.

4.2.1 TECHNOLOGY AND SOCIETY

Perhaps the most striking influence of technology is found on society. Practically every area of social life and the life of every individual has been, in some sense or the other changed by the developments in technology.

1. Technology Reaches People Through Business

Business is an institution through which man expects new discoveries to be converted into goods and services. Managers of business organisations pool the necessary resources and work on the new discoveries to convert them into useful products. New discoveries would remain mere ideas in mind, sketches on paper or mock models in laboratories but for the business institutions.

Printing, housing, education and television are all dependent on business activities to make them work productively. Society depends on business to benefit from new discoveries flowing into useful goods and services for all mankind. Developing countries have learnt that scientific discoveries mean very little to them unless they have competent business units to produce for people what science has discovered. Developed countries have learnt that their progress stops unless they operate a business system which contributes to discovery and uses discovery to produce for their people.

That technology reaches people through business is only part of the story. The economic prosperity of a nation (of which business is a part) depends on technology. 50% of economic growth of USA, UK, Germany, France, and Japan has come from technical progress achieved in these countries.

2. High Expectations of Consumers

Technology has contributed to the emergence of affluent societies. Affluent citizens want more of many things than more of same things. New varieties of products, superior in quality, free from pollution, more safe and more comfortable, are to be produced and supplied to the affluent sections. This calls for substantial investments in R & D. One important compulsion for investing in technological advances in Japan is its customer's high expectations regarding design sophistication, quality, delivery schedules and prices. Industry owners in Japan swear by the dictum-the customer is a god who is always right. High expectations of consumers pose a challenge and an opportunity to the owners of business institutions.

3. System Complexity

Technology has resulted in complexity. Modern machines work better and faster, no doubt. But if they fail, they need services of experts to repair. They fail often because of their complexity. A machine or a system is composed of several hundred components. All parts must work in tandem to accomplish a desired task. Reliable performance of each part, therefore, assumes greater significance.

4. Social Change

The role of technology on social change is enormous. There is the change in social life which results from a change in a technological process. Thus, an invention may destroy the economic basis of a city; displace thousands of workers; yet the same invention may result in the creation of a new city somewhere else and create even more jobs than it originally destroyed. Technological changes of this sort create a constant turmoil in society, with socially uprooted, mobile populations drifting about in search of new centres of employment. Sometimes, this drifting may result in a new geographical distribution of population; an example is provided by the constant drift of population centres of electronic or aerospace industries.

5. Technological Phase and the Social Systems they Create

Commencing from the later part of the 17th century till the end of 20th century, five stages of technological development can be traced. Each stage leaves a distinct influence on work and on the social system. In history, nations have tended to move sequentially through each phase, beginning with the lowest technology and moving higher with each step, so that the five stages of technology tends to dominate a nation's activities at a particular time, other phases often will be practised at the same time.

Of particular interest is the knowledge level of technology. At this level, technology creates a distinct type of social system, viz., knowledge society. In knowledge society, use and transfer of knowledge and information, rather than manual skill, dominates work and employs the large portion of labour force.

In the knowledge society, the relationship between the knowledge worker and the organisation will be strange and amorphous, redefining itself all the time. The knowledge-worker have to show why he should be retained, what benefit he can offer to the organisation, and how he can add value to whatever the organisation does. He will have to create new jobs in consultation with his employer. A job will then become a joint venture. When this happens, the worker can forget pension plans.

4.2.2 TECHNOLOGY AND ECONOMY

1. Increased Productivity

The most fundamental effect of technology is greater productivity in terms of both quality and quantity. This is the main reason why technology at all levels is adopted. In a hospital the objective may be qualitative, such as maintaining life with electronic monitoring equipment regardless of costs. In a factory, the objective may be quantitative in terms of more production at less cost.

As a result of productivity improvements, real wages of employees tend to rise and prices of some products decline, which spreads the beneficial economic effects of technology throughout the whole social system. The result is that employees and citizens are motivated to want more technological advancement, thereby placing on business major responsibilities to introduce it with due concern for its social and environmental effects.

2. Need to Spend on R & D

Research and Development (R&D) assumes considerable relevance in organisation as technology advances. In this context, firms are required to consider, decide and take action on atleast seven issues. **First**, is the allocation of resources to R&D. A company must make the required resources available for effective R&D. A company's R & D intensity (its spending on R & D as a percentage of sales revenue) is a principal means of gaining market share in global competition. Besides, consistence in resource allocation to R&D across lines of business improves corporate performance by enabling the firm to better develop synergies among product lines and business units.

Secondly, technology transfer, the process of taking new technology from the laboratory to the market place is equally important. This transfer takes larger time as organisations grow in size. The US based chemical giant Du Pont has long been known for its excellence in basic corporate research. In the early 1990's, for example, it led US chemical companies in patents applied for and granted. The company spent more than \$13 billion on chemical and related research during the 1980s but the management admitted that the company failed to develop much in the way of major innovations.

Thirdly, time factor is important in R & D. The time between innovation and commercialisation is getting considerably reduced.

Fourthly, as new technology comes in, the old technology needs to be abandoned. The process of old replaced by new is called **technological discontinuity**. Such discontinuity occurs when a new technology cannot be used simply to enhance the current technology but actually substitutes for that technology to yield better performance. The R&D manager must determine when to abandon present technology and when to develop or adapt new technology.

Fifthly, the firm must also decide on its own R & D or to outsource technology. The make or buy decision can be important to a company's R & D. Although in-house R & D has been traditionally an important source of technical knowledge for companies, firms can also tap the R & D capabilities of competitors, suppliers and other organisations through contractual agreements such as licensing, R & D agreements and joint ventures.

Finally, in the days to come, organisations will be required to spend vast sums of money on Research and Development in the area of bio-technology. Japanese are ahead of other countries in this emerging area. In simple terms bio-technology has been understood as the application of scientific and engineering principles to the processing of materials by biological agents to provide goods and services.

3. Jobs Tend to Become More Intellectual

With the advent of technology, jobs tend to become more intellectual or upgraded. A job hitherto handled by an illiterate and unskilled worker now required the services of an educated and competent worker. A clerical post in an office now demands the services of an expert in computers.

4. Problem of Technostructure

Not only jobs become more intellectual, even the incumbents tend to become highly professional and knowledgeable. An organisation which has adopted the latest technology is flush with scientists, engineers, college graduates and highly skilled workers on its payroll. Though such an organisation can boast of a progressive and modern outlook of its personnel complement, the problems such an enterprise has to face on this account are serious, to say the least. Motivation of such employees, for instance, is a difficult task. Such mundane incentives as attractive remuneration, job security and just treatment, hardly inspire the enlightened employees to work more. They are instead motivated by opportunities which offer challenges or growth and achievement. Secondly, retaining such employees for long is a difficult job. Being cosmopolitan in their outlook, these professional employees are known for organisational rootlessness and job-hopping. Flighting and not sticking to one company is their culture. The company has to make several exceptions to discourage rootlessness of its professionalised employees. Regular attendance and punctuality have to be relaxed; dual promotion ladders have to be established so that distinguished technical people can rise in rank; profit-sharing to be provided to give creative persons a financial stake in the ideas they create; attendance at professional get-togethers has to be sponsored; writing professional articles has to be encouraged; and special assignments and part-time teaching may be allowed. Thirdly, scientific and professional workers constitute, what Galbraith calls, the technostructure of a modern organisation. The technostructure tries to control the organisation through influencing management's decision-making. While there may be nothing wrong in making decisions prompted by the technostructure, the problem lies in the social effect that is involved. People constituting technostructure are experts, no doubt. But they are more action-oriented and are yet to learn social problems of business decisions. Management is, therefore, in a tight position to balance the ruffled feelings of technocrats and the social consequence of business decisions.

5. Need for Biprofessional and Multiprofessional Managers

Technocrats, who assume reins of administration, need to be qualified in management education in addition to the proficiency they have acquired in the chosen fields of specialisation. Today's business needs biprofessional and multiprofessional managers. To fill up a factory manager's post, for instance, the desired qualification stipulated is a degree in engineering and MBA from a recognised institution. The need for managers well-versed in different fields of knowledge is greatly felt now than ever before. Technological advancement has made the business more complex and its management more demanding.

Business and government must, therefore, spend more and more on spreading knowledge on know-how (technology) and do-how (management). Such a task is expensive but technology's greater productivity eases the burden of costly education and the training it requires.

6. Increased Regulation and Stiff Opposition

A by-product of technological advancement is the ever-increasing regulation imposed on business by the government of the land and stiff opposition from the public. The Government has the powers to investigate and ban products that are directly harmful or hurt the sentiments of a section of society. Import of animal tallow has been banned by the Government of India because the alleged mixture of tallow with vanaspati oil hurt the feelings of Hindus. Continuous struggle launched by the FMRAI (Federation of Medical Representatives of India) produced gainful results like banning the sale of harmful drugs and banning of sales promotion and advertisement of infant formula through the mass media.

7. Insatiable Demand for Capital

Today's technology necessitates massive investment of money on acquiring or discovering of new ideas and their adoption; educating, training and maintaining of the managers and the manged and on several other related areas. In fact, today's technology is characterised by its insatiable demand for capital. Business organisations should not only raise huge funds, exploiting all ways and means but the mobilised funds must be judiciously employed for gainful purposes. This calls for honest and efficient financial management. Qualified and competent people must be appointed to assume responsibility for financial management and should be given due place in the hierarchy of an organisation.

8. Rise and Decline of Products and Organisations

Change of technology, therefore, is a norm and not an exception. This poses another problem to business. A new technology may spawn a major industry but it may also destroy an existing one. Transistors, for example, hurt the vacuum-tube industry and xerography hurt the carbon-paper business. Television affected the business of radio broadcasting companies and movies and synthetic fibres reduced the demand for cotton fabrics. It is for this reason that Schumpeter saw technology as a force for 'creative destruction.' And it is precisely for the same reason that the saying, "Today's growth product is tomorrow's earthen pot", becomes relevant. Products, like mortals, have life-cycles. A typical product, today, is subject to a cycle: introduction, growth, maturity, decline and abandonment.

An organisation that is associated with a particular technology is influenced by it and will have the same life pattern as of the technology. Such an organisation will go in sequence through the introductory, growth, maturity and decline phases. The life of such an organisation may be composed of the following stages: (i) birth, (ii) growth, (iii) policy, (iv) procedure, (v) theory, (vi) religion, (vii) ritual, and (viii) last rites. In this eight-step sequence, an organisation is born and then has its growth. Policies are developed to guide decisions, and these are carried out through procedures. These procedures are refined and made more efficient with theories

about efficiency. In time, the organisation may develop characteristics of a religion, it may worship the way it does things. Performance is by ritual; things are done by habit without questioning. The death and last rites of the organisation will ordinarily follows.

9. Business Boundaries Redefined

- * Technological changes is a potent force in the reconfiguring of industry boundaries, it may broaden or narrow generally accepted industry boundaries.
- * As a consequence of its impact on whole industries, technological change can have a significant impact on the prevailing business definition of individual companies. Companies may find themselves in a different business due to technological changes that they or others have effected.
- * Technological change is one of the important factors giving rise to product substitution and product differentiation.
- * Technological change in the form of process (as opposed to product) and materials innovations may contribute to many of the impacts noted above.
- * Finally, for multi-product companies (preceding discussion applies to single-business units), technological change may have multiple impacts. For example, technological change can create new synergies across businesses or obsolete existing ones. Advances in telecommunications and computer technologies have made new synergies possible across business dealing with computers, television sets and communications.

Activity - B

1) What do you know about e-commerce?

2) Is it possible to eliminate all middlemen in the channel of distribution on account of ONLINE business transactions ? Suggest your view points.

4.2.3 PLANT LEVEL IMPLICATIONS

1. Technology and Organisation Structure

Technology has considerable influence on organisation structure, length of the line of command, and span of control of the chief executive. Where companies use technology which is fast changing, matrix structures are more common. Some companies use a matrix even though the rate of technological change is not fast. Besides technology, other factors which have their influence on organisation structure are history and background of a company and the personalities of the people who founded the firm and managed it subsequently but the impact of technology is considerable.

2. Fear of Risk

There is always the fear of risk. Take the case of DuPont's Corfam, an intended substitute for the forecasted shortage of shoe leather. After an investment of \$300 million, the company abandoned the project in 1971 because of quality and cost problems. Even a research-oriented company like DuPont, which was responsible for adding totally new dimensions to the textile industry with its introduction of synthetic fibres beginning in 1939, was unable to manage technology without great risks and some subsequent failures.

3. Resistance to Change

The manager of a given business unit shall face resistance to change. New technology poses new problems which may not be to the liking of the organisational men. The resistance to change is purely psychological.

A typical businessman himself is opposed to new technology. He does not encourage new technology. Reasons are not purely psychological. Adopting new technology is expensive and risky. When he is making enough money with obsolete technology why must he worry about new technology?

Specifically, resistance to change stems from the following reasons :

1. Psychological and social commitments to existing products, processes and organisation,
2. Sizable capital investments in long-life single-use-facilities,
3. Low profits and reduced rate of growth,
4. Small size or fragmented activities,
5. Complacent top management,
6. Industry norms and associations or cartels which perpetuate industry-bound thinking,
7. Lack of successful entrepreneurial models to emulate, and
8. Powerful labour resistance to changes in methods.

4. Total Quality Management (TQM)

Total Quality Management refers to deep commitment of an organisation to quality. Quality of product and service is an obsession and every step in the company's processes is subjected to intense and regular scrutiny for ways to improve it. Almost every issue is subject to exploration, and the process is a continuing one of long duration. Employees are provided with extensive training in problem solving, group decision making and statistical methods.

TQM has been introduced by almost all organisations. It has several implications for employees and organisations. Managers are required continuously to search for improved policies and activities. Employees can no longer rest on their past achievements. They too are required to search for newer and better ways of doing things. Some of them may experience stress from a work climate that no longer accepts complacency with the status-quo. Employees will be more and more involved in process improvement. Management will look at them as a source of improvement of ideas.

5. Business Process Re-engineering (BPRE)

Business Process Re-engineering essentially involves considering how things would be done if the organisation were to start all over from scratch. Michael Hammer is the father of the process re-engineering.

TQM and BPRE have identical objectives-search for excellence in serving the customers. But they differ in the means they adopt to reach the goal. TQM seeks to improve essentially what is good but BPRE seeks to reject what is irrelevant and starting afresh. Another feature which separates the two is-TQM is essentially a bottom-up approach, whereas BPRE is driven by top management.

BPRE is being considered essential in the modern competitive world. An organisation can survive the competition if it can cutdown its costs, eliminate waste and improve its product quality. Re-engineering helps the organisation achieve all these.

BPRE has certain implications for employees. Many of them may lose jobs because of reengineering efforts. Middle managers and clerical staff will be most vulnerable in this respect. Others who retain their jobs find that they are not the same any longer. The new jobs will require a wider range of skills, include more interaction with customers and suppliers, offer greater challenge, contain increased responsibilities and provide higher pay.

6. Flexible Manufacturing System (FMS)

Flexible manufacturing System (FMS) is another by-product of technology. Under FMS, machines are designed to produce batches of different products. Gone are the days of one machine producing multiple units of one component. It can now make dozens or even hundreds of different parts in any order management desires.

The unique characteristic of FMS is that by integrating computer aided design, engineering and manufacturing, they can produce low-volume products for customers at a cost comparable to what had been previously possible through mass production. In effect, FMS is rewriting the laws of economies of scale. Management no longer has to produce on a massive scale to achieve low unit-cost of production. With flexible manufacturing, when management wants to produce a new part, it does not change machines-it needs to change the computer programming.

Under FMS, workers need more training and higher skills. Besides, employees in flexible plants are typically organised into teams and given considerable decision making discretion. Organisational structure needs to be so designed so as to facilitate decentralisation of authority into the hands of operating teams.

Activity -C

- 1) Give an account of how the modern sophisticated technology have left Indian Industries in lurch.

- 2) What is the future of IT sectors in the years to come ? Say after (i) 10 years and (ii) 15 years.

4.3 SUMMARY

Technological environment implications on business has been discussed throughly emphasizing how society, economy and industries are affected by the constant innovations and inventions. The arrival of new products and vanishment of existing goods and services have also been studied in the context of change in technology.

4.4 SELF - ASSESSMENT TEST

1. What is technology? What are its features?
 2. Bring out the economic implications of technology.
 3. Bring out the salient features of our technological policy.
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4.5 FURTHER READINGS

1. T.S. Mann, Transfer of Technology, Bombay, Himalaya Publishing House.
2. William C. Frederick et. al, Business and Society, New York, McGraw Hill, 1997.
3. Hicks and Gullett, The Management of Organisations.

BRAOU

UNIT - 5 : SOCIO-CULTURAL ENVIRONMENT

Objectives :

After studying this unit, you should be able to :

- understand the nature of culture;
- know the impact of culture on business;
- realise the business participation in cultural affairs;
- comprehend the meaning of social responsibility of business - Arguments for and against it;
- know the barriers to social responsibility; and
- understand social responsibility implementation and limits of social responsibility.

Structure

- 5.1 Introduction
- 5.2 Nature of Culture
- 5.3 Impact of Culture on Business
- 5.4 Business Participation in Cultural Affairs
- 5.5 Social Responsibility of Business
 - 5.5.1 Arguments for Social Responsibility
 - 5.5.2 Arguments Against Social Responsibility
 - 5.5.3 Barriers to Social Responsibility
- 5.6 Social Responsibility Implementation
- 5.7 Limits of Social Responsibility
- 5.8 Summary
- 5.9 Self-Assessment Test
- 5.10 Further Readings

5.1 INTRODUCTION

Business being an integral part of society should react to the changing social and cultural environment. Managers of business can very well understand and also take effective decisions if they have thorough knowledge of the society in which they carry business.

Social and cultural environment refers to the influence exercised by certain social factors which are beyond the company's gate! Such factors include among others, attitude of people to work, attitude of wealth, family, marriage, religion, education, ethics, which are discussed below in this unit besides social responsibilities of business.

5.2 NATURE OF CULTURE

In its narrow sense, culture is understood to refer to such activities as dance, drama, music and festivals. In its true sense, culture is understood as that complex whole which includes knowledge, belief, art, morals, law, customs and other capabilities and habits acquired by an individual as a member of a society. "Culture consists of", writes Elbert W. Steward and James A. Gylmn, "the thought and behavioural patterns that members of a society learn through language and other forms of symbolic interaction-their customs, habits, beliefs, and values, the common viewpoints which bind them together as a social entity. Cultures change gradually, picking up new ideas and dropping old ones, but many of the cultures of the past have been so persistent and self-contained that the impact of any sudden change tears them apart, uprooting their people psychologically."

Thus, culture has two phenomena : shared values and passage of time. Culture of a society is shared by its members. Secondly, cultural ethos passed on from generation to generation. Culture is not confined to one particular period of time.

5.3 IMPACT OF CULTURE ON BUSINESS

The interface between business and culture is brought out in the following paragraphs.

1. Significance of Culture

The concept of culture is of great significance to business because it is the culture which generally determines the ethos of the people. It trains people along particular lines, tending to put a personality stamp upon them. Thus, we have Indians, Japanese, Americans, Germans, Britishers and so on. It is not that all people are alike in a particular culture. There are subcultures within a culture. People have their own idiosyncrasies and are a blend of heredity, cultural experience, subcultural experience, family experience, and unique personal experience.

When people with different cultural background promote, own and manage organisations, organisations themselves tend to acquire distinct cultures. Thus, the culture of the Tata group of companies is different from that of the enterprises owned by the Birlas.

2. Culture and Globalisation

As business units go international, the need for understanding and appreciating cultural differences across various countries is essential. Work motivation, profit motivation, business goals, negotiating styles, attitudes towards the development of business relationships, gift-giving customs, greetings, significance of body gestures, meaning of colours and numbers, and the like vary from country to country.

When people from different cultures converge in a workplace, management will be required to manage diversity. Work force diversity has important implications for management practice. Managers will be required to shift their philosophy from treating everyone alike to recognising differences and responding to those differences in way that will ensure employee retention and greater productivity while, at the same time, not discriminating. Diversity, if positively managed, can increase creativity and innovation in organisations as well as improve decision making by providing different perspectives on problems. Where not managed properly, diversity is likely to result in increased turnover, reduced communication and heightened inter-personal conflict.

Any move from one country to another will create a certain amount of confusion, disorientation and emotional upheaval. This is called **culture shock**. An executive transferred from India to Germany, for example, would require lot of adjustment to make. Language differs, climate varies, food habits are different and the socialisation pattern will be totally new. Culture

shock will be severe when the new environment is totally different from the old one. Organisations, particularly MNCs, must be prepared to cope with the culture shock.

3. Culture Determines Goods and Services

Culture broadly determines the type of goods and services a business should produce. The type of food people eat, the clothes they wear, the beverages they drink and the building materials they use to construct dwelling houses vary from culture to culture and from time to time within the same culture. Business should realise these cultural differences and bring out products accordingly.

The fact that culture determines the types of goods and services is not as important as its varied manifestations. Culture expresses itself through people's views of themselves, others, organisations, society, nature and cosmos.

4. People's Attitude to Business

Attitude of people towards business is largely determined by their culture. Business systems are a product of beliefs, mores and customs of the society in which they exist. Indeed, their very existence depends upon social philosophies which conduct and support various kinds of business actions. Businessmen (whether they realise it or not) must have some basic set of philosophies to guide their actions. Beliefs and value systems concerning what is right and what is wrong are basic to all business activities and serve as a justification for doing or not doing something in a particular value system by which actions of businessmen and other groups are judged. Usually, these actions are judged by how well they contribute to the net social well-being throughout the whole system.

5. Attitude to Work

How a worker looks at his work in a factory depends on his culture. Motivation, morale and other related aspects of human resource management are based on the worker's attitude to their work. Attitudes to leisure vary from country to country. Higher incomes may produce more work or more spare time. The work ethic means, in effect, that preoccupation with work is considered a virtue in some parts of the world and a vice in others. As a result, different types of appeal, reward and penalty are effective in different cultures.

6. Collectivism and Individualism

The spirit of collectivism and individualism is related to such personnel aspects as employee morale, multiplicity of trade unions and inter and intra-union rivalries. It is said that our culture stresses individual salvation and negation of the world. Behind a small charity or a good deed, it is pointed out, there is the motive of self, rather than society's welfare. This is the main reason for the low morale of our workers, multiple unions and the rivalries among them.

7. Ambitious or Complacent

An individual's ambition to grow or remain complacent depends on his cultural ethos. An ambitious individual is highly motivated, is wealth acquisitive, has a strong urge to excel, is prepared to change organisations and even take risks. Economy becomes vibrant if a large proportion of the population comprises ambitious people.

Majority of our people are known to be complacent. An average citizen will be happy to get into a government job (lower the order, the better) as it assures safety of tenure and demands no initiative, no skills and no hard work. He is not prepared to join the private sector as the job here demands hard work and high productivity. Complacency of citizens is attributed to be one of the reasons for the backwardness of our economy.

8. Education

The close interface of business and higher education is a new development. Centuries ago, each had a somewhat hands-off attitude towards the other. A relatively small section of the intellectual elite maintained their seclusion in university halls, educating a few selected students to become intellectual and social leaders of their nation. Education was not for the masses who laboured in factories, fields and stores. University education had little interest in business and businessmen had little interest in education. Each lived in a different world. Many educators showed an **elitist disdain** for businessmen who were perceived as less nobly motivated than educators. Most businessmen admitted that the disdain was mutual since men in the ivory tower had little that was practical to offer to business.

Things changed over the passage of time. Economy gradually shed its primitiveness and almost turned into an industrialised one, demanding technical education at all levels and of all castes. Educational institutions sprang up in all corners of the country and it is estimated that we have more number of primary schools than the USSR and USA put together. Vast sums have been spent on education in successive plans and a staggering sum of more than Rs. 29,000 crore had been allocated to education in the Seventh Plan alone.

Education benefits business. Business in turn has responded and started supporting education. This support is manifested in the starting and maintaining of educational institutions, sponsoring employees for continuing education and bearing the cost of the education of employees' children.

9. Family

Basic to all type of social organisations is the family, the institution which concerns itself with-love, sexual relationship, marriage, reproduction, socialisation of the child and the various levels of status and roles involved in kinship organisation. Little wonder that the family is referred to as a remarkable institution.

The family is important for a variety of other reasons, such as those relating to protection, inheritance, property rights, morality, care of the sick and the aged, and the transmission of cultural values.

Nuclear families have now become common in our society replacing the traditional extended family system. Women now enjoy equal status with men and most of them supplement family income by their own earnings. People have money and are prepared to spend on children's education, household appliances and on vacations. Children have become spenders instead of earners—a position they held in joint families. With big families being broken up, family businesses are slowly turning into limited companies. All these developments are significant to business.

10. The View of Scientific Method

It is said that, unlike Western society, our society is steeped in fatalism and the theory of Karma. The followers of our religion do not appreciate the logic of things—logic of wealth, rainfall, demand, supply, mechanisation and related phenomena. It is also said that they believe in preserving traditional mores and are not adaptive to things modern.

Contrary to popular belief, our views did not conflict with science. A study of the Upanishads will show that Vedanta postulates that the universe is the result of a gradual unfolding of the creative power inherent in the primordial substance. Infact, it may be said that the philosophy of our religion anticipated the basic theories of biology and physics. The very approach to things in the Upanishads, the insistence on adherence to truth and on tireless investigation is remarkable in the nature of an anticipation of the methods of science.

11. Ethics in Business

Ethics refers to the code of conduct that guides an individual in dealing with others. A formal definition of ethics is that it deals with personal conduct and moral duty and concerns human relations with respect to right and wrong. Ethics concerns morals and philosophy. It deals with the behaviour of individuals and the standards governing the interrelationship between individuals.

Is it enough if the manager, as an individual, is ethical in his behaviour and dealings? Many people believe so. This is, however, erroneous. Every individual has a responsibility of not only himself being ethical; he must make his group so. Ethical people doing nothing is the best way for moral decay to take over.

12. Religion

Religion refers to a specific and institutionalised set of beliefs and practices generally agreed upon by a number of persons or sects. The major religions across the world are Hinduism, Christianity, Islam and Buddhism. Each has its own distinct characteristics and followers.

Religion plays an important role in one's life. It makes an individual lead disciplined and orderly life. Religious practices relieve a person from tension. However tensed up an individual is, visit to a place of worship will make him/her feel psychologically relaxed and reassured.

The nature of business one runs also depends on religion. Birlas, being Jains, shun smoking and drinking. Hence, they have not entered into catering, hoteliering and leather industries. Islam prohibits money lending and the consumption of alcohol.

The economy of a nation may be affected by religion. One of the reasons why Burma has remained economically backward is its religion. According to local custom, every citizen in Burma must undergo monkhood for one year. It is said that Burmese have become lazy because of this practice. In Tibet and Sri Lanka too, hundreds of people take to monkhood and stay in monasteries. The services of these people could have been used for more productive purposes.

In a country like ours where people of several religious beliefs live, harmony among them is vital for business to flourish. Conflict between religions will destroy business prospects as was demonstrated when communal clashes broke out after the Ayodhya incident.

13. Marriage

Traditionally marriage had three objectives: the promotion of religion by the performance of household sacrifices, progeny whereby the father and his ancestors were assured of a happy afterlife and the line was continued and rati or sexual pleasure.

While the three objectives are relevant even today, what needs to be stressed is that the marriage is a social institution which results in the multiplication of people, settled life and systematised and organised activities. All these have economic significance.

Marriage also means several things to several people. A single marriage may spark off protest from women and approval from men. What is more, marriage may even revive a recession hit economy.

14. Time Dimension

Time dimension is another cultural aspect that will influence business. Time dimension refers to peoples' orientation-past, present or future. In some societies, people are oriented towards past. In others, they tend to be more focussed on the present. Still others are futuristic in their orientation. Business people in societies that focus on the present care more for the current well-being of companies they float. Employees are hired and maintained as long as they are useful to the organisations and are dispensed with once they cease to be so. Employee 71

training, job security and loyalty of service are unusual with such industrial societies. The American society is an example of this type. Japan is an example of futuristic society. The Japanese have very long-term future oriented time horizons. When Japanese firms hire employees they often retain them for a long time, even for life. The firms will spend a great deal of money to train them, and there is a strong, mutual commitment on both sides. Societies which are oriented towards the past tend to preserve past heritage. Concepts and actions of yore continue to guide current plans and strategies. Our society is a striking example for the past and future orientation.

Activity - A

An American businessman is interested to know about 'Indian Society' with particular reference to Indian Business community. List the points of observation you would like to share with him.

Activity - B

The food habits, clothing, ethos, taboos of South India is different from North India. Can you identify those factors and list below.

<i>Particulars</i>	<i>South India</i>	<i>North India</i>
(i) Food	Rice / Idly	Roti / Paav Bhaji
(ii) -----	-----	-----
(iii) -----	-----	-----
(iv) -----	-----	-----
(v) -----	-----	-----
(vi) -----	-----	-----
(vii) -----	-----	-----

5.4 BUSINESS PARTICIPATION IN CULTURAL AFFAIRS

Till now we described the various cultural factors which influence business generally. Specially, business does two things in the name of culture: (a) support to cultural activities; and (b) beauty in building design.

Support to cultural activities include such activities as employing artists and musicians, organising exhibitions of contemporary paintings, sponsoring cultural programmes through TV, instituting awards for excellence, sponsoring Sangeet Sammelans and maintaining Sangeet Research Academy as is done by the Indian Tobacco Company (ITC) in Calcutta.

Earlier beauty in the building was not considered in designing and constructing. Generally, factories and business buildings focussed mainly on utilitarian functions. The result was not just an absence of beauty, but distasteful; ugliness, sometimes called the 'nineteenth century ugly school of factory design.' Things are different now. Factory buildings are now constructed keeping in mind aesthetic values. Many factory sites are now industrial parks, more beautiful than the surrounding residential houses.

Why should business participate in the cultural affairs? Business justifies its involvement because of the better quality of life in the community. In turn, this quality of life improves recruiting and the retention of employees. It also improves satisfaction of the employees with their community, provides a better place for their children to grow up, and encourages each employee's own cultural growth. The effects continue in many directions in the same way that a stone cast into the water extends its ripples to the limits of the lake. If, for example, the firm sells its products locally, a community with a better cultural life should have improved chances of growth, thus providing more customers. Further, culture should attract better quality of citizens thus improving the quality of the labour pool from which the firm recruits. Cultural opportunities also may challenge youth in the community to raise their achievement, drives and provide favourable outlets for their energies, thereby reducing tendencies towards delinquency. In turn, less crime and delinquency may reduce the tax burden. When a system's view as this is taken, it can be argued that an instrument in community cultures tends to improve the entire social system.

5.5 SOCIAL RESPONSIBILITY OF BUSINESS

Social responsibility is understood as the obligation of decision-makers to take actions which protect and improve the welfare of society as a whole along with their own interest. Every decision the businessman takes and every action he contemplates have social implications. Be it deciding on diversification, expansion, opening of a new branch, closure of an existing branch or replacement of men by machines, the society is affected in one way or the other. Even routine matters like overtime and night shifts, subcontracting, and laying off employees due to load-shedding have a social impact. Whether the issue is significant or not, the businessman should keep his social obligation in mind before contemplating any action.

Activity - C

List the social responsibility measures undertaken by the firms in your region.

5.5.1 ARGUMENTS FOR SOCIAL RESPONSIBILITY

There are many arguments in support of socially responsive actions. More important of them are explained below:

1. Changed Public Expectations of Business : One of the most potent arguments for social responsibility is that public expectations from business have changed. It is reasoned that the institution of business exists only because it satisfies the valuable needs of society. Society gave business its charter to exist, and the charter can be amended or revoked at any time that the business fails to live up to society's expectations. Therefore, if business wishes to remain viable in the long run, it must respond to society's needs and give the society what it wants.

2. Better Environment for Business : Another argument favouring social responsibility is that it creates a better environment for business. This concept rationalises that a better society produces environmental conditions more favourable for business operations. The firm which is most responsive to the improvement of community quality of life will as a result have a better community in which to conduct its business. Labour recruiting will be easier, and labour will be of a higher quality. Turnover and absenteeism will be reduced.

As a result of social improvements, crime will decrease with the consequence that less money will be spent to protect property, and less taxes have to be paid to support police forces. The arguments can be extended in all directions to show that a better society produces a better environment for business.

3. Public Image : Another argument in favour of social responsibility is that it improves public image. Each individual firm seeks an enhanced public image so that it may gain more customers, better employees, more responsive money markets and other benefits. A firm which seeks better public image should support social goals.

4. Avoidance of Government Regulation : Government is a massive institution with long arms. It seeks to regulate business in the public interest. Government regulation is costly and denies the much needed freedom in decision making. Before the government stretches its long arms, business should discharge its obligation to society.

5. Balance of Responsibility with Power : Another argument for social responsibility is that business's responsibility should be more related to its power. It is reasoned that businessmen have vast amounts of social power. They do affect the economy, minorities, and other social problems. In turn, an equal amount of social responsibility is required to match their social power. If each institution is to perform its social role in an orderly relationship with other institutions, then responsibility must be accepted whenever there is power. Any other arrangement invites irresponsible behaviour.

6. Business has the Resources : Another argument for social responsibility is that business has a vast pool of resources in terms of men, talents, functional expertise and money. Probably, business is without peers in respect of the resources it possesses. With these resources at its command, business is in a better position to work for social goals.

7. Let Business Try : One interesting argument for business social responsibility is a sort of back-handed one. It is that many other institutions have failed in handling social problems, so why not turn to business. Many people are frustrated with the failures of other institutions, and in their frustration, they are turning to business.

8. Prevention is Better Than Cure : Another point is that prevention is better than cure. If business delays dealing with social problems now, it may find itself constantly occupied with putting out social fires so that it has no time to accomplish its goal of producing goods and services. Since these social problems must be dealt with at some time, it is actually more

economical to deal with them before they develop into serious social breakdowns that consume most of the management's time.

9. Moral Responsibility : It is said that the acceptance of corporate social responsibility is the morally correct position. This notion suggests that our modern industrial society faces many serious social problems brought on, to a large extent, by large corporations. The corporations therefore have a moral responsibility to help solve or ameliorate these problems. A corollary to this notion is that because business firms control so many of the resources in our economy, they should devote some of these resources to the overall betterment of society.

10 Citizenship Argument : Corporations are institutional members of society. If individual members of the society have an obligation to improve society-to leave the world better than they found it-corporations also have this responsibility. After all, corporations unlike citizens, are created by society. Corporations are citizens, and citizens have civic duties and responsibilities.

11. Duty of Gratitude : Business units benefit from society. On the basis of the commonly accepted principle that one owes debts of gratitude towards those who benefit us, the corporation has certain debts that it owes to the society.

5.5.2 ARGUMENTS AGAINST SOCIAL RESPONSIBILITY

Arguments against social responsive actions are equally strong. Some arguments are as follows:

1. Profit Maximisation : The first and the most forceful argument disfavouring social responsibility is that business has profit maximisation as its main objective. Infact, the business is most socially responsible when it attends to its interests and leaves other activities to other institutions. Since business operates in a world of poverty and hunger, the economic efficiency of business is a matter of top priority and should be the sole mission of business. Business's function is economic, not social and economic values should be the only criteria used to measure success. In this kind of system, managers are the agents of the stockholders, and all their decisions are controlled by their desire to maximise profits for the stockholders while reasonably complying with law and social custom.

2. Society has to Pay the Cost : Another argument is that the costs of social responsibility will be passed on to the the society and it is the society which must bear them. Can the society afford these additional costs?

3. Lack of Social Skills : Business managers are best at managing matters relating to business. They are not equally good at solving social problems. Their outlook is primarily economic and that their skills are the same. They really do not feel at home in social matters. If society is going to depend on someone to work with social problems, why choose a group which is so poorly qualified? Does society really want economic and technical people meddling in social affairs? Will they broaden their outlook and will their skills transfer? Can business really do the job? Is it better equipped than the government and other institutions?

This problem is, however, sought to be overcome to a considerable extent. We have a number of fairly high calibre institutions, like the Xavier Institute of Social Sciences and Institute of Rural Management, Anand (IRMA), which train students specifically for social work. Corporates like the Lalbhai, Mafatalals and Shroffs have already attempted to bring in management professionals into the social responsibility area.

4. Business has Enough Power : Another argument is that business already has enough social power, therefore, society should not take any steps which give it more power. According to this line of reasoning, business is one of the two or three most powerful institutions

in society at the present time. Business influence is felt throughout society. It is felt in education, in government, in the home and in the market-place. It moulds many social values. The process of combining social activities with the established economic activities of business would give business an excessive concentration of power. Business is an institution which is considered to be not so good and giving more power to it is not advisable.

5. Social Overhead Cost : Cost on social responsibility is considered to be a social cost which will not immediately benefit the business. Why spend money on an object, the benefits of which will be realised only in the future? It is the heavy social overhead cost which is one of the reasons for the dismal performance of some of our government undertakings.

6. Lack of Accountability : Another point of view is that the businessmen have no direct accountability to the people, therefore, it is unwise to give businessmen responsibility for areas where they are not accountable. Accountability should always go with responsibility, and it is poor social control to allow any other kind of arrangement. Until the society can develop mechanisms which establish direct lines of social accountability from business to the public, business must stand clear of social activities and pursue only its goal of profit where it is directly accountable through the market system.

7. Lack of Broad Support : Another point is that business involvement in social goals lack support from all groups in society. If business does become socially involved, it will create so much friction among dissident parties that business cannot perform its social assignment. Although many persons desire business to become more socially involved, other oppose the idea. There is lack of agreement among the general public, among intellectuals, in the government and even among businessmen themselves.

8. Friedman and Levitt's Views : The most cogent criticism has been voiced by the economist Milton Friedman. Friedman based his arguments on two principal contentions, one economic and one legal. From the economic perspective, he asserted that if managers spend corporate funds on projects not intended to maximise profits, the efficiency of the market mechanism will be undermined and resources will be misallocated within the economy. On the legal side, Friedman contended that because managers are legal agents of the stockholders, their sole duty is to maximise the financial return to the stockholders. Hence, if they spend corporate funds for social purposes, they are essentially stealing from the stockholders. Moreover, Friedman suggested that if the stockholders want money spent on social causes, they are free to do so individually with their dividends.

Theodore Levitt argued against corporate social responsibility fearing that business values might come to dominate society. He posited that business, as an institution, would become the twentieth-century equivalent of the medieval church-the-all-embracing institution in society. He suggested that this would not be healthy for society.

Nearer at home, we have Dhirubhai Ambani, of Reliance fame, who is opposed to corporate social responsibility. "As an industrialist my job is", declared he, "to produce goods to satisfy the demand. Let us be very clear about it. Everyone has to do his job. My commitment is to produce at the cheapest price and the best quality. If you dabble in everything then you make mess of things. If we cannot take care of our shareholders and employees and start worrying about the world, then that is hypocrisy".

Business and Society : Indian Situation

Whatever may be arguments for and against social responsibility of business, it is gratifying to note that in India, several leading companies have exhibited greater social responsibilities. The corporate sector in India has been responsible and instrumental in setting many public institutions like schools, hospitals, technological institutes, libraries, cultural institutions, and

charitable institutions. On the other hand, business enterprises are also responsible for degradation of ecological environment. The problem of environment pollution caused by several industrial enterprises in India, has become very serious and sometimes threatening the existence of life and prosperity in some parts of the country. Several public sector institutions in the Country also functioned in such a way that they benefited few managers, employees, suppliers, bureaucrats, and politicians at the cost of ordinary man in the society. Continuous huge losses, inefficiency and mismanagement of these undertakings resulted in more harm to the society than the petty help the society received from these enterprises.

5.5.3 BARRIERS TO SOCIAL RESPONSIBILITY

Efforts to achieve greater social responsibility encounter practical problems at every level of the organisation. Awareness of the problems is helpful to take steps to overcome them.

The Individual Manager : The individual manager is the person who is ultimately responsible for the social action programmes of any organisation. The manager can initiate, advocate, and put programmes into effect. The manager can also balk, hinder, and prevent programmes from being planned or implemented. Almost all employees in business are employees. Their careers may be in jeopardy if they consistently advocate actions of which their superiors disapprove or if they make unprofitable trade-offs. For this reason, most managers are cautious about proposing significant changes in their organisation's behaviour.

The Organisation : At the organisation's level, the greatest barrier is the focus on profits. Social action projects must always be evaluated in terms of the net cost. Shareholders want profits distributed in dividends or invested to expand production. Employees want higher salaries and better working conditions. Against these competing claims, social programmes may have little chance.

The Industry : There may not be support from competitors in the same industry for social action programmes.

The Division : Like the organisation of which it is part, a division must try to maintain itself as a profit centre. Any social responsibility decision that reduces the level of profit might threaten the division's viability. Thus, most divisions are slow to initiate socially responsible programmes until they receive clear instructions to do so from the top management.

5.6 SOCIAL RESPONSIBILITY IMPLEMENTATION

Social responsibility has two facets : first, to whom the business is accountable and the second, business's responsibility to society. The first relates to accountability of business to its owners, employees, government and consumers. This accountability is popularly called corporate accountability in the literature available on the subject. Corporate accountability is discussed in this section.

Irrespective of the facet of social responsibility, two processes are essential in developing organisation's social responsiveness. First, it is necessary to establish methods of monitoring social demands and expectations in the external environment. Secondly, it is important to develop internal social response mechanisms.

Monitoring Social Demands and Expectations

Important means of assessing social needs and expectations relating to organisations include social forecasting, opinion surveys, issues management, social scanning and social audit.

Social Forecasting : This is the systematic process of identifying social trends, evaluating the organisational importance of those trends and integrating these assessments in the organisation's forecasting programme. One approach to social forecasting is the use of futurists, individuals who track significant trends in the environment and attempt to predict their impact on the organisation, usually 10 or more years. Hence, some organisations use consultants and research institutes that specialise in social forecasting.

Opinion Surveys : Associations and major business publications often conduct surveys of public opinion on various issues of social concern. These surveys often provide feedback to companies regarding the perceptions of social responsibility among various groups.

Issues Management : This is the process of identifying a relatively small number of emerging social issues of particular relevance to the organisation, analysing their potential impact and preparing an effective response. Typically, 10 to 15 issues are identified, but the number can vary depending on organisational circumstances. Issues management attempts to minimise 'surprises' resulting from environmental forces and to facilitate a proactive stance towards environmental change. Issues management helps identify a definable social need, a potential source of serious stockholder concern, or the likelihood of government action. Once identified, firms will try to resolve the issue before it reaches a critical stage.

Social Scanning : Social scanning is the general surveillance of various elements in the environment to detect the evidence of impending changes that will affect the organisation's social responsibilities. Unlike issues management, social scanning is usually done on an informal and unsystematic basis. Executives frequently draw upon their own experiences of factors that are likely to have important organisational implications. They may also rely on data from more systematic assessments.

Social Audit : This is a systematic study and evaluation of social actions of an organisation. It includes an assessment of the social impact of a firm's activities, an evaluation of programmes specifically aimed at achieving social goals, and a determination of areas in need of organisational action. Social audits are difficult to carry out because disagreements can arise regarding what should be included, results can be difficult to measure, and interpretations of what is adequate or good social performance are likely to vary. Nevertheless, companies are increasingly implementing social audits to assess their social action programmes.

Internal Social Response Mechanisms

The most common internal response mechanisms used by firms include executives, temporary task forces, departments or combinations of these.

In relatively small firms, individual executives are required to handle social issues, as and when they occur. In some companies, temporary task forces are constituted to deal with a critical issue. When the issue is resolved, the task force is disbanded. Many companies will have permanent departments that coordinate various ongoing social responsibilities, identify and recommend policies for new social issues. Popularly called the *Public Affairs Department*, such a department may be responsible for coordinating government agencies, community relations and other external activities. In practice, organisations may use a combination of mechanisms to enhance social performance.

Corporate Accountability

Coming to the facets of social responsibility, business's responsibility is mainly towards (i) employees, (ii) consumers, (iii) government and (iv) owners.

(A) Towards Employees : Responsibility towards employees is in the form of just selection, training, promotion, fair wages, levelling out variations in employment, comfortable

working conditions, safety and health, social measures, scope for initiation and advancement, participative management, workers' education and the like.

It is heartening to note that most business establishments are fully aware of their responsibility towards their employees and are doing a lot for their improvement. The first name to be mentioned is the Tatas who have no peers in the pursuit of labour welfare. It was the Tatas who first introduced many welfare measures for the benefit of their employees and several years later, the government made them compulsory for other business houses to follow.

No wonder an individual takes it as a pride and deems it a privilege to join the 150,000 members of the Tata family employed in more than 32 companies, dotting all over the country. Similarly, Godrej & Boyee, Shriram Industries and TVS group are good employers.

(B) Towards Consumers : Responsibility towards consumers includes such aspects as producing and supplying quality goods at reasonable prices, avoiding creation of artificial scarcities, revealing truth in advertising and labels, keeping up the delivery schedules, providing prompt after-sales services, preventing formation of monopolies with the intention of exploiting customers and guaranteeing the buyers about the lifetime performance of the products.

In respect of responsibility towards consumers, the performance of our businessmen is far from satisfactory, honourable exceptions notwithstanding. The consumer is not the king in our country but a vehicle conveniently used by businessmen for driving towards to goal of profit maximisation. Government is interfering in a big way to protect the interests of consumer and consumers themselves are forming into a movement, popularly called consumerism to protect their interests against business malpractices (consumerism is discussed in detail in the next unit).

(C) Towards Government : Business responsibility towards the government covers such areas as complying with all legal requirements, paying taxes honestly, executing government contracts, making services of executives available for the government, deducting income tax and amounts to be invested in national savings certificates from wages and salaries of employees and acting as a willing partner with the government in pursuit of public welfare.

In respect of responsibility to the government, our businessmen have come under dark clouds. The series of raids conducted on business houses and the reasons made known for the raids demonstrate clearly that businessmen have failed to discharge their responsibility towards the government.

(D) Towards Owners : Corporate accountability towards owners covers such areas as managing the business profitably, ensuring fair and regular return on capital employed, guaranteeing capital appreciation and consolidating the financial position of the business so that it can withstand fluctuating fortunes so common in business.

5.7 LIMITS OF SOCIAL RESPONSIBILITY

The social responsibility actions of businesses are limited by cost, efficiency, relevance and scope. As a result of these constraints, actions fall short of public expectations.

Cost

Social responsibility costs money. Whether a company desires to adopt a village, donate to a college or school, build a hospital, maintain parks or undertake relief operations in times of calamity, it costs money.

Efficiency

Social responsibility affects efficiency adversely. Being obliged to the employees, say a company runs its plant, even if it is incurring losses every year. Its efficiency goes down and its ability to compete is lost.

Relevance

According to several critics, business has no obligation to society. The only obligation is to run the business successfully. Social responsibility is irrelevant. According to Friedman, for example, "There is one and only one social responsibility of business : to use its resources and energy in activities designed to increase its profits so long as it stays within the rules of the game...(and) engages in open and free competition, without deception and tend...". Friedman contends that corporate officials are in no position to determine the relative urgency of social problems or the amount of organisational resources that should be committed to a given problem. He also insists that managers who devote corporate resources to pursue personal, and perhaps misguided notions of the social good, unfairly tax their own shareholders, employees and customers. In short, business should produce goods and services efficiently and leave the solution of social problems to the concerned individuals and government agencies.

Scope and Complexity

Society's problems are too massive, too complex, and too deep seated to be solved by even the most socially conscientious company or even by all companies acting together.

The problems such as environmental pollution-acid rain, ozone depletion, destruction of rain forests; health problems-AIDS, drug and tobacco use; racial discrimination; sex discrimination; ethnic and religious animosities and the like defy solutions however conscientious one might be.

Business has its own limitations. Still business can help society at macro and micro levels. It cannot and should not escape from this important responsibility.

5.8 SUMMARY

In this unit an attempt has been to know how far cultural factors-family, marriage, religion, the values etc., influence the business firm regarding what to produce and when? Business participation in cultural affairs are also discussed. Lastly, the social responsibility of business in toto been dealt with.

5.9 SELF-ASSESSMENT TEST

1. Define culture. How does culture influence business?
2. Discuss why business should participate in cultural affairs?
3. Why is social responsibility important for business?

5.10 FURTHER READINGS

1. William M. Kaphart, The Family, Society and The Individual.
2. Aileen D. Ross. The Hindu Family in its Urban Setting.
3. Keith Davis and Robert Blomstrom, Business and Society - Environment and Responsibilities.

UNIT - 6 : BUSINESS ETHICS AND CORPORATE GOVERNANCE

Objectives

After studying this unit you should be able to

- know the meaning of the term 'ethics', business ethics, sources of business ethics;
- know why is ethics important?
- digest ethical dilemmas and how to manage ethics?
- know the techniques of ethical decision making;
- get an idea about nature of corporate governance and factors influencing CG; and
- know the mechanisms of Corporate Governance

Structure

- 6.1 Introduction
- 6.2 Nature of Ethics
- 6.3 Sources of Business Ethics
- 6.4 Why is Ethics Important
- 6.5 Ethical Dilemmas
- 6.6 Managing Ethics
- 6.7 Improving Ethical Decision Making
- 6.8 Nature of Corporate Governance
- 6.9 Why Corporate Governance?
- 6.10 Factors Influencing Corporate Governance
- 6.11 Mechanisms of Corporate Governance
- 6.12 Summary
- 6.13 Self-Assessment Test
- 6.14 Further Readings

6.1 INTRODUCTION

Business ethics is the study of good and evil, right and wrong and just and unjust actions of businessmen. The business actions should be judged by the general ethical standards of society. It is the moral responsibility of the business houses to tender good quality of goods and services, avoid adulteration, use of faulty weighing machines, hoarding, creating artificial demand for the essential commodities. Avoiding or evading taxes to the government, causing environment pollution, and law breaking are common in business. It is the chief executive officer who should take initiative in ensuring ethical standards in his organisation by following code of ethics.

Corporate Governance is concerned with the formulation of long-term objectives and plans and the proper management structure (organisations, systems and people) to achieve them. The structure to ensure corporate governance includes the board of directors, top management, shareholders, creditors and others.

In our country, Corporate Governance is gaining momentum of late. The Confederation of Indian Industries (CII) is actively engaged in this respect by bringing out Corporate Governance Code under the Chairmanship of Rahul Bajaj. The code was articulated and implemented in many of the corporate houses.

6.2 NATURE OF ETHICS

Ethics refers to a system of moral principles- a sense of right and wrong and goodness and badness of actions and their motives and consequences. Business ethics refers to the application of ethics to business. To be more specific, business ethics is the study of good and evil, right and wrong and just and unjust actions of businessmen.

Business ethics does not differ from generally accepted norms of good or bad. If dishonesty is considered to be unethical and immoral in society, then any businessman who is dishonest with employees, customers, shareholders or competitors is acting unethically and immorally. If protecting others from any harm is considered to be ethical, then a company that recalls a defective and harmful product from the market is acting ethically. To be considered ethical, businessmen must draw their ideas about what is desirable behaviour from the same sources as anybody else. Businessmen should not try to evolve their own principles to justify what is right and wrong. Employees and employers may be tempted to apply special or weaker ethical rules to business situations. But society does not condone or permit such an exception. People who are in business are bound by the same ethical principles that apply to others.

Two theories are pertinent when one talks about the nature of ethics.

The **theory of moral unity** essentially advocates the principle that business actions should be judged by the general ethical standards of society. There exists only one ethical standard which applies to business and to non-business situations.

Opposed to the theory of moral unity is the **theory of amorality**, which argues that business can be amoral, and the actions of businessmen need not be guided by general ethical standards. Managers may act selfishly because the market mechanism distills their actions into benefits to shareholders and society at large. Adam Smith argued that the 'invisible hand' of the market assures that by "**pursuing his own interest (a merchant) frequently promotes that of the society more effectively than when he really intends to promote it.**" In this way, capitalism provides moral justification for the pursuit through behaviour which is not purposefully ethical.

However, the theory of amorality is not acceptable to anybody. Everyone agrees that business actions should be subject to the same ethical standards as the one applicable to the society in general.

6.3 SOURCES OF BUSINESS ETHICS

Managers in every society are influenced by three repositories of ethical values: religion, culture and law.

Religion

One of the oldest sources of ethical inspiration is religion. More than 100,000 different religions exist across the globe. But despite doctrinal differences, the major religions converge on the belief that ethics is an expression of divine will that reveals the nature of right and wrong in business and other areas of life. The world's great religions are also in agreement on fundamental principles which are similar to the building blocks of secular ethical doctrine. The principle of reciprocity towards one's fellow human beings is found in all major religions such as

Hinduism, Buddhism, Christianity, Islam, Judaism and Confucianism. The great religions preach the necessity for an orderly social system and emphasise social responsibility in such a way so as to contribute to the general welfare. Built upon such verities are many other rules of conduct.

Cultural Experience

Culture refers to a set of values, rules and standards transmitted among generations and acted upon to produce behaviours that fall within acceptable limits. These rules and standards always play an important part in determining values, because, individuals anchor their conduct in the culture of the group.

The Legal System

Laws are rules of conduct, approved by legislatures, that guide human behaviour in any society. They codify ethical expectations and keep changing as new evils emerge. But laws cannot cover all ethical expectations of society. Law is reactive; new statutes and enforcement always lag behind the opportunity for corporate expediency.

Whatever ethics that law codifies, it is binding on business. Society expects business to abide by law and obeying law is presumed to be ethical behaviour.

Although society expects business to be law abiding, seldom does the business adhere to the rules. Law breaking in business is common. Taxes are evaded, hundreds of employees die because of occupational diseases, many die because of industrial accidents and million others receive disabling injuries on the job. The blame for these deaths and injuries can be shared by careless employees and by employers who fail to adhere to occupational health and safety laws.

Consumers suffer because of poor quality and high priced products supplied by businessmen. And business causes misery to the society by damaging the environment and disregarding environment protection laws.

Activity - A

Is it possible to eliminate all unethical practices in business. Substantiate your answer.

6.4 WHY IS ETHICS IMPORTANT

Ethics is important to business for several reasons as stated below:

- 1) **Ethics corresponds to basic human needs :** It is a human trait that man desires to be ethical, not only in his private life but also in his business affairs where, being a manager, he knows his decisions may affect the lives of thousands of employees. Moreover, most people want to be part of an organisation which they can respect and be publicly proud of, because they perceive its purpose and activities to be honest and beneficial to the society. Most top managers would like to respond to this need of their employees; and they (managers) themselves feel an equal need to be genuinely proud of the company they are directing. These basic ethical needs compel the organisations to be ethically oriented.

- ii) **Values create credibility with the public :** A company perceived by the public to be ethically and socially responsive will be honoured and respected even by those who have no intimate knowledge of its actual working. There will be an instinctive prejudice in favour of its products, since people believe that the company offers value for money. Its public issues will attract an immediate response.
- iii) **Values give management credibility with employees :** Values are supposed to be a common language to bring leadership and its people together. Organisational ethics, when perceived by employees as genuine, create common goals, values and language. The management has credibility with its employees precisely because it has credibility with the public. Neither sound business strategy, nor a generous compensation policy and fringe benefits can win employee credibility; and perceived moral and social uprightness can.
- iv) **Values help better decision making :** Another point of great importance is that an ethical attitude helps the management make better decisions, i.e., decisions which are in the interest of the public, their employees and the company's own long term good, even though decision making is slower. This is so because respect for ethics will force a management to take various aspects-economic, social, and ethical-in making decisions.
- v) **Ethics and Profit :** Ethics and profit go together. A company which is inspired by ethical conduct is also profitable one. Value driven companies are sure to be successful in the long run, though in the short run, they may lose money.
- vi) **Law cannot protect society, ethics can :** Ethics is important because the government, law and lawyers cannot do everything to protect society. Technology develops faster than the government can regulate. People in an industry often know the dangers in a particular technology better than the regulatory agencies. Further, government cannot always regulate all activities which are harmful to society. Where law fails, ethics can succeed. An ethical oriented management takes measures to prevent pollution and protect worker's health even before being mandated by law.

6.5 ETHICAL DILEMMAS

Several ethical dilemmas confront a manager. The ethical dilemmas stem from three sources; face-to-face ethics, corporate policy ethics and functional-area ethics.

Face-to-Face Ethics : These arise mainly because there is a human element in most business transactions. For example, a purchasing agent may develop personal relationship with the sales representative who sells supplies to a company; they frequently know one another on a first-name basis, have lunch together and talk often on the phone. A company's best customers may be well known to people in the production department; it helps to ensure that the company's products fit the customer needs.

Because business is composed of these human transactions, it should not be surprising that face-to-face ethical dilemmas arise often.

It is likely that the quality assurance man winks at minor defects and approves a lot delivered by a supplier because of the personal relationship the two enjoy between them. It is also not unlikely that the supervisor over-rates the performance of an employee because of the similar relationship that exists between the two.

Corporate Policy Ethics : Companies are often faced with ethical dilemmas that affect their operations across all departments and divisions. Following conflicting situations are typical :

- (a) Your R & D department has modernised one of your products. It is not really 'new and improved' but you know printing this statement on the package and using it in the advertisement will increase sales. What would you do?
- (b) You are interviewing a former product manager who just left a competitor's company. You are thinking of hiring him. He would be more than happy to tell you all the competitor's plans for the coming years. What would you do?
- (c) You have a chance to win a big account that will mean a lot to you and our company. The purchasing agent hinted that he would be influenced by a gift. Your assistant recommends sending a fine colour television set to his home. What would you do?
- (d) You produce an anti-dandruff shampoo that is effective with one application. Your assistant says that the product would turn over faster if the instructions on the label recommended two applications. What would you do?
- (e) You work for a cigarette company and up to now have not been convinced that cigarettes cause cancer. A recent report has come across your desk that clearly establishes the connection between cigarette smoking and cancer. What would you do?

Functional Area Ethics : Functional areas of business are likely to confront ethical issues. Accounting is a critical function of any business. Accounting statements reveal to the managers and owners about the financial soundness of a company. Managers, investors, regulating agencies, tax collectors and trade unions rely on accounting data to make key decisions. Honesty, integrity and accuracy are absolute requirements of the accounting function. Professional accounting organisations have evolved generally accepted accounting standards whose purpose is to establish uniform standards for reporting accounting data. When they are followed, these standards ensure a high level of honest and ethical accounting disclosures. Rarely are they followed in practice.

6.6 MANAGING ETHICS

In the past, it was assumed in most companies that ethics was a matter of individual conscience. But the scenario has changed. Today, many companies are using managerial techniques that are designed to encourage ethical behaviours. Some of the managerial interventions to ensure ethical conduct are explained below:

Top Management

It is the chief executive officer who should take initiative in ensuring ethical standards in his organisation. The words of J.R.D. Tata are worth recollecting in this context. ".....has also worked against our growth. What would have happened if our philosophy was like that of some other companies which do not stop at any means to attain their ends. I have often thought of that and I have come to the conclusion that if we were like these other groups, we would be twice as big as we are today. What we have sacrificed is a 100 percent growth."

In addition, management must avoid adopting business strategies, schedules and reward systems that place unreasonable pressure on employees.

Code of Ethics

Code of ethics have become popular. Codes vary from book-length formulations to succinct statements which in one or two pages, express a general philosophy for managing conflicts. Nearly 95 per cent of Fortune 500 companies have codes and the trend is visible in our corporate sector also.

Ethics Committees

Many companies have ethics committees to advise on ethical issues.

Such a committee can be a high-level one comprising the board of directors, chaired by the CEO of the company.

The committees field questions from employees, help the company to establish policy in new or uncertain areas, advise the board of directors on ethical issues and oversee the enforcement of the code of ethics.

Ethics Hot Lines

In some companies, when employees are troubled about some ethical issue but may be reluctant to raise it with their immediate supervisor, they can place a call on the company's 'ethics hot line'. A member of the ethics committee receives the confidential call and then quickly investigates the situation. Elaborate steps are taken to protect the identity of the caller, so as to encourage more employees to report any deviant behaviour. This technique is advantageous in as much as ethics hotlines encourage internal whistle-blowing, which is better for a company than to have disgruntled employees take their ethical complaints to the media.

Ethics Training Programmes

Nearly all companies which take ethics seriously provide training in ethics for their managers and employees. Such training programmes acquaint company personnel with the official company policy on ethical issues, and they show how those policies can be translated into the specifics of every day decision making. Often, simulated cases based on actual events in the company are used to illustrate how to apply ethical principles to on-the-job problems.

Generally speaking, ethics training is most effective when it is conducted by company managers, and is steered away from abstract philosophical discussions to focus on specifics from the work environment of those attending.

Ethics and Law

Law and ethics aim at one thing—defining proper and improper behaviour. But the two are not quite the same. Laws are a society's attempt to formalise—that is, to reduce to written rules—ideas about what is right and what is wrong in various walks of life. However, it is rarely possible for written rules to capture all the subtle shadings that people give to ethics. Ethical concepts are more complex than written rules. Ethics deals with human dilemmas that frequently go beyond the formal language of law and the meanings given to legal rules.

Similarities and differences apart, legal rules help promote ethical behaviours in organisations. Some of the Acts which seek to ensure fair business practices in our country are the following:

The Foreign Exchange Regulation Act, 1973 now replaced by FEMA

The Companies Act, 1956

The Monopolies and Restrictive Trade Practices Act, 1969

The Consumer Protection Act, 1986

The Environment Protection Act, 1986

The Essential Commodities Act, 1955

Activity - B

1. Name the companies which are following Code of Ethics

2. Name the companies which are having Ethical Committees in our country.

3. List the companies specialised in 'Ethics Hot Lines'.

6.7 IMPROVING ETHICAL DECISION MAKING

Ethical decisions are difficult to make. They cannot be programmed like production and inventory decisions. But decisions need to be made in business. This section contains practical difficulties in decision making and guidelines which help a manager in making a choice.

Difficulties in Decision Making

There are number of reasons why decision making becomes difficult.

First, managers face dilemmas in deciding on a course of action.

Second, managers confront a distinction between facts and values when making ethical decisions.

Third, good and evil exist simultaneously, in tandem and interlocked.

Fourth, knowledge about the consequences of an action is limited. One of the principles of decision making is utilitarian. This implies that if an act results in the greatest good of greatest numbers, it is taken as morally acceptable. This principle assumes that the consequences of the act are knowable. But in an uncertain business environment, consequences cannot be easily predicted.

Fifth, some ethical standards vary with the passage of time. Donations to political parties were forbidden earlier but it is allowed now. In addition, bribes and payments are accepted practices in Asian, African and Latin American countries but are not regarded as ethical in the US. Doing business with close friends and family is a standard practice in the Arab world but is treated as nepotism in Western Europe.

Sixth, the ethical behaviour is moulded from the cray of human imperfection. Unethical practices abound everywhere. An honest manager finds himself like a babe in the woods, not able to do anything, surrounded as he is, by dishonesty anywhere.

Seventh, the early 21st century presents managers with new and emerging ethical problems that are not solved easily with traditional ethical guidelines. For example, modern ethical theory has not yet developed an adequate principle for weighing human life against economic factors in a decision. Cancer studies may predict that workers exposed to chemicals will become ill in small numbers far in the future. How should this information be balanced against costs of regulation, capital investment or job loss?

Finally, the growth of large scale organisations in the 21st century gives new significance to ethical problems such as committee decision making that masks individual responsibility, organisational loyalty to the public interest and preferential hiring of disadvantaged sections of society. These are ethical problems peculiar to large organisations.

Practical Suggestions for Making Ethical Decisions

Individuals in business can take a number of steps to resolve ethical problems.

First, consider some decision tactics that illuminate moral choices. One such device is to engage in imaginary conversations with a hypothetical opponent as an antidote for certitude. Have a conversation or debate with an intelligent person who takes a different view. Seek out a more experienced, ethically sensitive person in the organisation to be your adviser. Alternatively, write an essay in favour of a stand and then a second, opposed to it. Write a case study in the third person about your situation. Try to apply ethical principles in answers to questions raised by the case.

Second, write down pros and cons in the form of a balance sheet. The balance sheet approach helps decision making by presenting information in an organised way.

Third, sort out ethical priorities before problems arise. Prioritisation shall help consider alternatives when one is not under stress.

Fourth, one should commit oneself publicly on ethical issues. He should identify potential areas of ethical conflict and make clear his opposition to padding expense accounts, stealing supplies from the company, price fixing or damaging ecology. Once the stand is made clear, co-employees will be less tempted to approach with corrupt intentions.

Fifth, one should set a good personal example for employees.

Finally, ethical perfection is illusory. We live in a morally complex civilisation with profuse rules, norms, obligations and duties existing like road signs that generally point in the same direction, but sometimes do not. No method of decision making ends conflicts, no principle penetrates unerringly to the good, no manager achieves an ethical ideal.

Realisation of the fact that there can be no ethical perfection helps a manager considerably.

So far we discussed, in detail, business ethics and corporate social responsibility. The central theme of all this discussion is that a business unit should operate in an ethical and socially responsive way. Who are the people to ensure such a behaviour from a company? What mechanism does exist to ensure that the people involved in running a business operate in the way that is expected of them? This unit seeks to answer these and other related issues.

Models of Business Conduct

Thus, there is no need to emphasize that all business undertakings must need certain ethics. But we cannot expect uniform business codes of conduct as each business got its own image. Prof. Clarence C. Walton has explained the following models of business conduct.

1. **Austre Mode :** In this type the business gives exclusive emphasis on ownership interest and profit objective. This type of business will always be cost conscious in every activity. This firm will be conservative in outlook.
2. **Household Mode :** In this type of model, the firm gives extension of the benefit to the employees with a condescension of paternalism. This type of business is analogous to a family or household consisting of shareholders, management and employees whose benefit will be looked after.
3. **Vendor Model :** In this type of business, consumers interests, tastes and rights would be given priority and consumer satisfaction would be dominating the organisation.
4. **Investment Model :** The focus of this model is on the organisation as an entity and thus on long-term profits and survival. It gives recognition to social investments along with economic investments.
5. **Civil Model :** Under this model, the business accepts the social responsibility and makes a positive commitment to social needs. Its slogan is 'corporate citizenship'.
6. **Artistic Model :** In this model the organisation becomes a creative instrument serving the cause of an advanced civilisation with a better quality of life.

Activity - C

What are your suggestions for making ethical decisions ?

6.8 NATURE OF CORPORATE GOVERNANCE

Corporate governance is the overall control of activities in a corporation. It is concerned with the formulation of long-term objectives and plans and the proper management structure (organisation, systems and people) to achieve them. At the same time, it entails making sure that the structure functions to maintain the corporations' integrity and responsibility to its various constituencies.

The structure to ensure corporate governance, for our purpose, includes the board of directors, top management, shareholders, creditors and others. Role of each of these stakeholders is crucial in guaranteeing responsible corporate performance. Before examining the role of each of these groups, it is useful to understand the relevance of corporate governance in the present context.

6.9 WHY CORPORATE GOVERNANCE?

Corporate governance has been an active subject of academic and policy debate for quite a long time in many of the advanced countries, particularly the US, UK, Germany, and Japan. The international competitiveness and successful functioning of companies in these countries has of late, alerted company owners and managers in the developing and transition economies to the fact that effective corporate governance is crucial for competitiveness and success in the long run. Infact, the importance of corporate governance has been highlighted by

international agencies like the OECD and the World Bank. In particular, the World Bank has been in the process of formulating a draft code on corporate governance for developing countries that would review the principles of effective governance, built on international guidelines, assess governance practices in emerging markets, and distil the best practices from these and developed countries.

In our country, while several mechanisms of governance have formally been in place for much a longer time than in most of the developing countries, the issues of proper governance has assumed pertinence only recently. In fact, the lack of adequate governance of Indian companies has been highlighted in academic circles and other forums as one of the primary reasons for under performance of industrial establishments.

At least three reasons have triggered off concern in corporate governance in our country.

First, since 1991, the country has moved into liberalised economy and one of the victims of the market-based economy is transparent fair business practices. In the survival of the fittest scenario, norms and principles are thrown to the winds. Infact, a number of company failures have been reported in the recent past. Several instances of mismanagement have been alleged with some well-known and senior executives being hauled up for non-performance and / or non-compliance with legal requirements. Some norms of behaviour to ensure responsive behaviour are of great help.

Second, both domestic as well as foreign investors are becoming more demanding in their approach towards the companies in which they have invested their funds. They seek information and want to influence decision. Increasing integration with global markets calls for a correspondingly improving compliance with global practices in all spheres of corporate activity.

Third, interest of non-promoter shareholders and those of small investors are increasingly being undermined. Several MNCs, for example, have sought to set up 100 per cent subsidiaries and transfer their business (carried through Indian joint-venture partners) to them. In many cases, there was no thought of consultation with non-promoter shareholders whose interest would be affected.

Again, well known Indian companies, in recent years, raised funds in the GDR markets abroad and in India for specific objectives. But these funds were diverted to investments elsewhere, without consulting the shareholders. Obviously, the sufferers are the minority shareholders.

6.10 FACTORS INFLUENCING CORPORATE GOVERNANCE

Four factors influence corporate governance, namely, (i) the ownership structure of a corporation, (ii) its financial structure, (iii) the structure and functioning of the company boards and (iv) the legal, political and regulatory environment within which the company operates.

The Ownership Structure

The structure of ownership of a company determines, to a considerable extent, how a corporation is managed and controlled. The ownership structure can be either dispersed among individual and institutional shareholders as in the US and UK or can be concentrated in the hands of a few large shareholders as in Germany and Japan. But the pattern of shareholding is not as simple as the above statement seeks to convey. The pattern varies across the globe. According to a study on corporate ownership conducted in 1998, 36 per cent of the firms in the world are widely held, 30 per cent are family controlled, 18 per cent are state controlled and the remaining 15 per cent are in miscellaneous categories.

Our corporate sector is characterised by the co-existence of state owned, private and multinational enterprises. The shares of these enterprises (except those belonging to the public sector) are held by institutional as well as small investors. Specifically, shares are held by (i) the term-lending institutions (ii) institutional investors, comprising government owned mutual funds, Unit Trust of India and the government owned insurance corporations (iii) corporate bodies (iv) directors and their relatives and (v) foreign investors. Apart from these block-holdings, there is a sizeable equity holding by small investors.

Which pattern of shareholding, dispersed or concentrated, is ideal for good corporate performance? Large shareholders tend to be active in corporate governance either through their representatives on company boards or through their active participation in annual general body meetings. This has been demonstrated by Reliance Industries Ltd. which has the highest number of equity shareholders spread across the country. Block-holding too has not proved to be a failure either. Dominant shareholders are better informed than the dispersed shareholders. Under the concentrated ownership structure, as has been demonstrated through the Bajaj Group, corporate performance tends to be better.

The Financial Structure

Along with the notion that the structure of ownership matters in corporate governance is the notion that the financial structure of the company, i.e. proportion between debt and equity, has implications for the quality of governance. Contrary to the Modigliani-Miller hypothesis that the financial structure of the firm has no relationship to the value of a firm, recent research has shown that the financial structure does matter. It is no secret that the lenders exercise significant influence on the way a company is managed and controlled. Banks as creditors, for example, can perform the important function of screening and monitoring companies as they (banks) are better informed than other investors. Further, banks can diminish short-term biases in managerial decision making by favouring investments that would generate higher benefits in the long run. Also, banks, because of the close financial relationships they foster with the companies to which they lend, and in some cases because of their nominees on company boards, are considered to play a more favourable role than other investors in reducing the costs of financial distress.

The Structure of Company Boards

Along with the structure of ownership, the structure of company boards has considerable influence on the way the companies are managed and controlled. The board of directors is responsible for establishing corporate objectives, developing board policies and selecting top-level executives to carry out those objectives and policies. The board also reviews management's performance to ensure that the company is run well and shareholders' interests are protected.

Company boards are permitted to vary in size, composition and structure so as to best serve the interests of the corporation and the shareholders. Board membership may include both inside directors and outside directors. Again, boards can be single-tiered or two-tiered.

With regard to the size of board, opinions and practices vary. Some argue that the adequate size is to range from nine to fifteen. Some others put the figure at ten and yet others recommend a minimum of five and maximum of ten. Company boards in the UK have, on an average, seven directors on their boards. Japanese companies have larger boards, the figure going upto sixty. A quick survey of the thirty companies actively traded on the Bombay Stock Exchange, and which form the basis for Sensex Index, reveals that as of 31st March, 1997, the median number of directors in these companies was 13.5, with 20 and five at the extremes. The corresponding numbers as of 31st March, 1994 were median 12, high 21, and low five. It should be noted that it is the quality of the directors, the interests they take, and the roles that they assure which are more important than mere numbers or composition.

The Institutional Environment

The legal, regulatory, and political environment within which a company operates determines in large measure the quality of corporate governance. In fact, corporate governance mechanisms are economic and legal institutions and often the outcome of political decisions. For example, the extent to which shareholders can control the management depends on their voting rights as defined in company law, the extent to which creditors will be able to exercise financial claims on a bankrupt unit will depend on bankruptcy laws and procedures; and the extent to which the market for corporate control efficiency operates to discipline underperforming management will depend on take-over regulations.

6.11 MECHANISMS OF CORPORATE GOVERNANCE

The fundamental institutions of corporate governance in our country have been in existence for a long time. Compared to many developing countries, mechanisms of corporate governance in India are much more institutionalised. However, in spite of such institutions corporate governance has not been a major issue until the announcement of the new economic policy in 1991. Since then, corporate governance has assumed great relevance for reasons stated earlier.

In our country, there are six mechanisms to ensure corporate governance: (i) The Companies Act, 1956; (ii) The Securities and Exchange Board of India (SEBI) Act, 1992; (iii) a market for corporate control; (iv) participation of block shareholders in the governance of companies; (v) statutory audit; and (vi) Code of Conduct.

Companies Act

Companies in our country are regulated by the Companies Act, 1956, as amended up-to-date. The Companies Act is one of the biggest legislations with 658 sections and 14 schedules. Through the consolidation of many successive amendments, and a large number of statutory rules and regulations, the Act aims at not only ensuring that the interests of all stakeholders are adequately protected but purports to go beyond. The Act, to some extent, seeks to translate into action Articles 38 and 39 in Part IV of the Constitution, by which the State was directed that the ownership and control of the material resources of the community are so distributed as to subserve the common good and the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

The arms of the Act are quite long and touch every aspect of company's existence. But to ensure corporate governance, the Act confers legal rights to shareholders to (a) vote on every resolution placed before an annual general meeting; (b) to elect directors who are responsible for specifying objectives and laying down policies; (c) determine remuneration of directors and the CEO; (d) removal of directors and (e) take active part in the annual general meetings.

The Companies Bill, 1997 and the recently promulgated Ordinance on Companies (Amendment) Bill, 1997, have amended several provisions of the Act and introduced new provisions incorporating some internationally accepted corporate governance practices aimed at strengthening corporate democracy, protecting the interests of minority shareholders and providing maximum flexibility to the companies in responding to the market needs. Among these, the amendments that have made headlines are permitting companies to buy back shares and the liberalisation of inter-corporate investments.

Securities Law

The primary securities law in our country is the SEBI Act. Since its inception in 1992, the Board has taken a number of initiatives towards investor protection.

One such initiative is to mandate information disclosure both in prospectus and in annual accounts. While the Companies Act itself mandates certain standards of information disclosure, SEBI Act has added substantially to these requirements in an attempt to make these documents more meaningful. One of the most valuable is the information relating to the performance of other companies in the same group, particularly those companies which have accessed the capital market in the recent past.

Another aspect of the SEBI regulations is that in most public issues, the promoters (typically the dominant shareholders) are required to take a minimum stake of about 20 per cent in the capital of the company and to retain these shares for a minimum lock-in period of three years.

Yet another area in which SEBI has laid down guidelines, relates to prohibiting preferential allotments to dominant shareholders at a price lower than the average market price during the preceding six months.

Finally, the Board constituted a Committee under the chairmanship of Kumaramangalam Birla to suggest ways to promote and raise the standards of corporate governance in listed companies. The Board, in its meeting held on January 25, 2000, considered the recommendations of the Committee and decided to make amendments to the listing agreements by adding a new clause, namely clause 49, to the listing agreement.

Discipline of the Capital Market

Capital market itself has considerable impact on corporate governance. Herein lies the role the minority shareholders can play effectively. They can refuse to subscribe to the capital of a company in the primary market and in the secondary market, they can sell their shares, thus depressing the share prices. A depressed share price makes the company an attractive take-over target.

A debt-holder too has a role to play in disciplining a company's management. Unlike the shareholder who is a residual claimant, the creditor has contractual rights to reclaim his interest and principal, and this enable him to monitor the actions of the management. Most debt contracts involve covenants that make it less easy for the dominant shareholders to indulge in gross abuses. The ability of debt holders to monitor the company is quite high because typically, they are large institutions with high stakes.

In a well functioning capital market, there is a strong incentive for corporate managements themselves to voluntarily adopt transparent processes and subject themselves to external monitoring to reassure potential investors. An untested management group is likely to find that the market places a 'management discount' on them that reflects what the market has come to expect of management groups in general. The management then has every incentive to take steps that will reduce this by making governance abuses more difficult. In the last few years, we have seen Indian companies voluntarily accepting international accounting standards though they are not legally binding. They have voluntarily gone for greater disclosures and more transparent governance practices than are mandated by law. They have sought to cultivate an image of being honest with their investors and of being concerned about shareholder value maximisation.

What makes capital market discipline so much more attractive than regulatory intervention is that unlike the regulator, the market is very good at micro level judgements and decisions. Infact, the market is taking micro-decisions all the time. It is its success in doing so that makes it such an efficient allocator of capital. Unlike the regulator, the market is not bound by broad rules and can exercise business judgement. It therefore makes sense for the regulator to pass on as much of the burden of ensuring corporate governance to the markets as possible. The regulator can then concentrate on making the markets more efficient at performing this function.

Nominees on Company Boards

Development banks hold large blocks of shares in companies. They are equally big debt holders too. Being equity holders, these investors have their nominees in the boards of companies. These nominees can effectively block resolutions which may be detrimental to their interests. Unfortunately, the role of nominee directors has been passive, as has been pointed out by several committees including the Bhagavati Committee on Takeovers and the Omkar Goswami Committee on Corporate Governance.

Statutory Audit

Statutory audit is yet another mechanism directed to ensure good corporate governance. Auditors are the conscience-keepers of shareholders, lenders and others who have financial stakes in companies.

Auditing enhances the credibility of financial reports prepared by an enterprise. The auditing process ensure that financial statements are accurate and complete, thereby enhancing their reliability and usefulness for making investment decisions. Credible financial statements are essential for business enterprises to raise capital and for society to have trust in limited companies. Obviously, good corporate governance depends, in part, on good auditing.

Codes of Conduct

The mechanisms discussed till now are regulatory in approach. They are mandated by law and violation of any provision invites penal action. But legal rules alone cannot ensure good corporate governance. What is needed is self regulation on the part of directors, besides of course, the mandatory provisions.

The Confederation of Indian Industry (CII) issued a draft code of 'Desirable Corporate Governance' for the Indian industry in April 1997, in response possibly to the Finance Ministry's veiled threats that soften the self-regulatory regime, greater the likelihood of harsher government regulations.

The CII Code, leaning heavily on the British model, is based on the explicit assumption that "good governance helps to maximise shareholder value, which will necessarily maximise corporate value and, thereby, satisfy the claims of creditors, employees and the State." Whether the code will stimulate a change in corporate governance, only time will tell.

Activity - D

Please visit the nearest Confederation of Indian Industries office and get a copy of 'Corporate Governance Code'. After going through it, suggest measures to improvise the same.

6.12 SUMMARY

In this unit the nature of ethics, business ethics, its sources, importance, dilemmas, managing ethics have been discussed. Apart from that the meaning and definition of Corporate Governance, its significance, and factors affecting the same are also analysed.

6.13 SELF-ASSESSMENT TEST

1. What do you understand by ethics? Why is ethics important for business?
 2. How is ethics managed in a business unit?
 3. Define Corporate Governance. Why is it assuming greater relevance now a days?
 4. State and explain the mechanisms of Corporate Governance.
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6.14 FURTHER READINGS

1. Theophane A. Mathias, "Corporate Ethics", Allied Publications.
2. R.M. Lala, "Creation of Wealth".
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BLOCK-II : STRUCTURE OF THE INDIAN ECONOMY

After studying Block-I, you might have got familiarity about different dimensions within which the business and service organisations have to function. In this block, we are explaining you how our economy was structurized. Unit-7 of this block explains the Five Year Plans of our country, their objectives, their priorities, etc. Unit-8 deals with the important changes that have taken place in different areas like savings, investment, price level, monetary factors, populaation, demographic factors, so on and so forth. Various components of India's industrial sector, growth of our industrial sector and other related aspects were discussed in Unit-9.

After the introduction of New Economic Policy, the Government of India is showing interest in privatizing both government and public sector organisations. Unit-10 explains various issues relating to privatisation like the meaning of the term privatisation, its advantages and disadvantages, etc. Last unit in this block is devoted to discuss small business, its increasing importance in our economy, etc.

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UNIT - 7 : ECONOMIC PLANNING IN INDIA

Objectives :

After reading this unit you will be able to :

- Understand and explain the meaning of and the need for economic planning;
- Explain the origin of national economic planning and the socio-economic objectives of the Indian five years plans;
- Understand resource mobilization and allocation pattern of plan outlays of public sector;
- Understand and explain the achievements during the planning era; and
- Understand and explain the factors responsible for major setbacks during the process of planned economic development in India.

Structure :

- 7.1 Introduction
- 7.2 Factors Contributing to the Adoption of Planning for Development
- 7.3 Meaning and Need for Planning the India - Successive Five Year and Annual Plans
- 7.4 Socio - Economic Objectives of Planning in India
- 7.5 Priorities and Outlays of Successive Five Year Plans
- 7.6 Economic Growth Record During the Planning Era
- 7.7 Factors Responsible for Periodic Setbacks During the Planning Era
- 7.8 New Economic Policy (1991) and the Future of Planning in India
- 7.9 Summary
- 7.10 Self - Assessment Test
- 7.11 Further Readings

7.1 INTRODUCTION

In the earlier units you are introduced to different dimensions of the environment within which commercial, industrial and other business enterprises have to function. These dimensions you have studied include economic environment, political, legal and technological environment and Socio-cultural environment. You have also learnt from unit 6 the meaning of and need for business ethics. Enterprises in their activities should show necessary concern for the society and social good. This applies to both non-corporate and corporate enterprises. After making yourself thorough with the business environment surrounding different enterprises supplying goods and services, you need to understand as many details as necessary about planning in India. Because India has economic planning right from early 1950s. Economic planning in India has played an important part in not only directing the development process but also in creating institutions, regulatory framework with a view to ensure achieving of socio-economic objectives through economic development. These in turn have influenced the environment within which business enterprises have to carry out their activities. Economic planning for development has become an integral part of governmental efforts for overall economic development. In this unit you learn about planning in India.

7.2 FACTORS CONTRIBUTING TO THE ADOPTION OF PLANNING FOR DEVELOPMENT

As a basic idea, which governs behaviour of individuals, households, and enterprises, planning is as old as the beginning of the organised human existence. A head of the household (with some division of labour between wife and husband), an entrepreneur, the decision making body in a corporate enterprise, all in practice are accustomed to plan their day to day activities and formulate their plans for future. As in case of government, households and enterprises have budgets to properly plan their expenditures in consonance with their incomes. Enterprises which undertake various kinds of investments in the present period with the expectation of getting reasonable rate of return in future, as you know, will resort to capital budgeting. Households also need planning to ensure for themselves all requirements such as houses and durable consumer goods. Thus, in modern times, planning of some kind has become as integral part of the life of human beings. While this is so, several factors have inspired national economic planning in India and some other countries in the 20th century. Now we turn to these factors.

When India achieved independence in 1947, the economy was in a stagnant state with widespread poverty and very little by way of industrial development. Poverty, illiteracy, social and economic inequalities, severe regional imbalances, and many other socio-economic problems prevailing at that time made the first generation political leaders of the post-independent India to realise the Herculean task before them, the task of achieving overall development of India, ensuring progressive rise in levels of living of the people along with social and economic justice. In tackling the myriad economic and other problems, the first Prime Minister Pandit Jawaharlal Nehru opted for domestically systematic national economic planning and internationally, by now familiar, non-alignment policy. In respect of planning, Nehru was inspired by the success of the Soviet Union with central economic planning. This is an important factor for introducing planning in India. This is the reason why late C. Rajagopal Chary, a famous statesman and prolific writer, made the following comment about the Indian planning :

“Indian planning is a Russian Child, brought up in India and fed by the milk of America”. It is a Russian child, because central economic planning originated in the Soviet Union. As planning proved to be a success in the Soviet Union, Nehru adopted planning for India. Because Nehru implemented planning in India, planning has become an adopted child. In financing our economic plan we relied to some extent on American economic aid (Fed by the milk of America). National economic planning implies active state intervention and important role for government in country's economic activities. The two world wars necessitated reconstruction and rapid development of western economies. Some of these economies opted for some kind of economic planning. In this connection you have to remember the large-scale foreign economic aid programmes of the United States to help war damaged countries in their rapid economic recovery, the prominent example being Japan.

Another factor to be noted in this connection is the so called **“Keynesian Revolution”**. It has clearly brought out the short coming of capitalist system and the need for state intervention in economic activity. Historically unregulated capitalism in the western world was marked by economic fluctuations (frequent ups and downs), 1930's great depression dramatically brought out this evil associated with capitalism. The largely capitalistic western world at the time, was influenced by the keynesian revolution to formulate and implement macroeconomic policies, among others, to ensure economic stability. Fiscal policy for economic stability assumed significant importance in the eastern capitalist economies. Market failures associated with the capitalist system further strengthened the need for state intervention. For example, market failure in ensuring production of optimal quantities of output in the presence of externalities, external economies and external diseconomies. An industry experiencing external diseconomies will produce more output than socially optimal output. This is the consequence of market failure in

the presence of externalities and market failure justifies state intervention. Thanks to the Keynesian revolution and other research results in the field of economics, now we have nowhere the virgin pure capitalism in the world. The capitalism as it exists today in the Western and other countries is controlled or regulated capitalism.

India required large-scale investments for infrastructure and basic and heavy industrial development. Further, India at the time of independence, was predominately an agricultural country. Agriculture was characterized by traditional and outdated methods of production resulting in low productivity. Farming was largely on subsistence basis with a little commercialisation and production for the market. More than 80 percent of land was dependent on monsoon. Agriculture was in need of irrigation facilities. Land ownership pattern and other insitutional conditions warranted radical reforms. There was need for major, medium and minor irrigation projects. All these required systematic planning to assess the resource requirements, resource mobilisation and resource deployment to achieve balanced development of different sectors of the economy. Central economic planning was found to be the best means for achieving rapid economic development. The soviet experience with central economic planning provided the necessary assurance for the political leadership to initiate and go ahead with economic planning. Thus several factors were behind the introduction of planning in India from early 1950's.

Activity - A

1. Review your understanding of factors which led to the introduction of national economic planning in India.

2. "Planing is a Russian Child" - Explain.

3. Market failures in a capitalist economy warrant state invention in economic matters - Explain with suitable illustrations.

7.3 MEANING AND NEED FOR PLANNING IN INDIA-SUCCESSIVE FIVE YEAR AND ANNUAL PLANS

Economic planning may be described as a deliberate governmental attempt to coordinate economic decision-making over the longrun and to influence, direct and control the level and the growth of a country's important economic variables such as income, consumption, employment, investment, savings, exports and imports to achieve a pre-determined set of socio-economic objectives. An economic plan is simply a specific set of quantitative economic targets to be reached in a given period of time through mobilisation of necessary resources and proper allocation of resources among sectors and sub-sectors. The period of time chosen by planners is 5 years. This is the reason why Indian plans are named as five - year plans (no doubt for various reasons there were plan holidays and consequently only annual plans during some of the years in planning era in India). Right from the beginning India has gone in for comprehensive planning. A comprehensive plan sets its targets to cover all major aspects of the national economy. Comprehensive economic planning involves several steps. In the Indian case the following are these major steps:

1. Starting from the political views and the goals of government, planning attempts to define policy objectives, especially as related to the future development of the economy.
2. A development plan sets out a strategy by means of which it intends to achieve these objectives, which are normally translated into specific targets.
3. The plan attempts to present a centrally co-ordinated, internally consistent set of principles and policies chosen as the optimal means of implementing the strategy and achieving targets and intended to be used as a framework to guide subsequent day to day decisions.
4. It covers whole economy.
5. To secure optimality and consistency, the comprehensive plan employs a more or less formalised economic macroplanning model to project the intended future performance of the economy (In India starting with second five year plan, for each plan there was a planning model, for example Mahalanobis Four-Sector planning model formed the basis for second five year plan).

Starting with a pre-determinate economic growth target (national income growth rate) the required aggregate saving investment rate is determined. This can be illustrated in the following way. If political leadership in consultation with country's planners fixes the growth rate target to be 7 per cent (Annual average National Income growth rate) then the following basic growth rate equation is used in determining the required investment rate.

$$\text{Target Growth Rate} = \frac{\text{Rate of Investment}}{\text{Incremental Capital - Output Ratio}}$$

On the basis of the past data and expected future changes planners have to assume a suitable Incremental Capital-Output Ratio (ICOR). If planners think ICOR during the plan period is given to be 4, then the above equation is used to determine the required rate of investment. For the numerical values we have assumed above, the growth equation enables the determination of the required rate of investment. The above equation can be written as:

$$\begin{aligned} \text{Rate of Investment (required)} &= \text{Target Growth Rate} \times \text{ICOR} \\ &= 7\% \times 4 = 28\% \end{aligned}$$

Thus, in order to achieve 7% growth target given the ICOR, country needs to invest 28% of national income or must achieve 28% investment rate (investment-national income ratio). If country's saving rate falls short of required investment rate, the country must seek foreign savings (in the form of aid of different categories). India has been depending to some extent on foreign capital-concessional foreign aid, foreign commercial loans, foreign direct and portfolio investments. Once the growth target and required investment are taken care of, the two important remaining steps are:

1. Mobilisation of financial and physical resources required to achieve sectoral, sub-sectoral and economy wide plan targets.
2. The allocation of resources among sectors and sub-sectors commensurate with the relevant targets.

Thus planning is a detailed empirical exercise underlying which we have plan strategy, resource mobilisation and allocation of resources.

India has already gone through the following five year and annual plans. Tenth plan is an ongoing one.

First Plan	(1951-56)
Second Plan	(1956-61)
Third Plan	(1961-66)
Three Annual Plans	(1966-69)
Fourth Plan	(1969-74)
Fifth Plan	(1974-79)
Annual Plan	(1979-80)
Sixth Plan	(1980-85)
Seventh Plan	(1985-90)
Two Annual Plans	(1990-92)
Eighth Plan	(1992-97)
Ninth Five Year Plan	(1997-2002)
Tenth Five Year Plan	(2002-2007)

As for the administrative machinery for the planning, the Planning Commission of India was established in 1950. National Development Council was formed in 1952 through executive orders. Both are non-statutory bodies, and hence their allocations and recommendations are non-mandatory. This is the reason why the plans prepared by the Planning Commission and approved by the National Developmental Council must be presented to the Parliament and only after Parliament's approval the plans are implemented.

Activity - B

1. Explain the terms plan and planning.

2. If growth target is 6.5 percent and the ICOR is 6, find out the required investments rate to achieve the growth target. Assuming the domestic saving rate to be 23 per cent, find out the foreign capital requirement.

3. What are the steps involved in formulating a five - year plan?

7.4 SOCIO - ECONOMIC OBJECTIVES OF PLANNING IN INDIA

The long-term objectives of economic planning in India have been spelt out in various plan documents. We briefly state and explain each of the main objectives below:

1. Economic Growth

Economic growth or growth in national income is a must for overall economic development and improvement in levels of living. India is a country with large and growing population, which needs rapid economic growth to achieve significant improvements in levels of living. The enormity of the problem becomes clear if we compare growth in national income with growth in population. We later present the growth rates achieved during different Plan periods. Here it is enough to note that per capita income growth rate is equal to national growth rate minus population growth rate. Given the national growth rate, the higher is population growth rate, the lower is the per capita income growth rate. So through planning we should try not only to accelerate national income growth rate but also to reduce population growth rate. Accelerating economic growth rate is thus a very prominent objective of economic planning in India.

2. Removal of Unemployment

India is a country with large work force. Unemployment has been a chronic problem. Unemployment problem has not only adverse economic consequences but also undesirable social and political consequences. It is necessary to ensure through planning adequate growth in employment opportunities commensurate with growth in labour force.

3. Reduction in Economic Inequalities

At the time of independence Indian economy and society were characterised by extreme inequalities. These inequalities in economic and social realm needed proper tackling through planning and public policies. There were islands of affluence in an ocean of poverty. Glaring inequalities are productive of social and economic conflicts. To achieve social and economic harmony in the country, it is necessary to reduce progressively economic inequalities and social injustice. Right from the beginning of the planning, growth objective received more attention than justice objective. But growth with equity objective received greater attention from the 5th Plan onwards until the introduction of New Economic Policy in 1991.

4. Elimination of Poverty

It is correctly said that poverty anywhere is inimical to plenty everywhere. Progressive reduction of levels of poverty has been an important objective of economic planning. In early 1950's more than 60 per cent of Indian population were living below the poverty line (poverty line is a cut off point defined in terms of either minimum monthly or annual income or minimum calories required, the number of people below the poverty line constitute the poor). Both employment generation programmes and anti-poverty programmes have become an integral part of Indian economic planning since the beginning of the 1970's.

5. Modernisation Including Technological Upgradation

At the time of the beginning of the planning era, Indian economy was characterised by traditional agriculture (largely subsistence agriculture with outdated methods, practices and institutions) and technological dualism. The economy was in need of modernisation. Modernisation of agriculture, technological upgradation in respect of industry and other sectors, inculcation of attitudes and behaviour patterns more conducive to longrun economic development were needed. The scientific outlook must replace superstition and fatalist beliefs. The planning should pay adequate attention to development of science and technology. In order to achieve higher and higher productivity levels in different sectors, modernisation is required in respect of methods of production, organisation, attitudes and behaviour patterns.

6. Self - Reliance

Dependence always results in exploitation, with the bitter experiences during the colonial rule and with the strong faith that political independence without economic strength amounts to nothing inspired the political leadership to pursue the objective of self-reliance through economic planning. Continued dependence on rich countries proved to be harmful to the interests of developing countries in general and India in particular. For example, during the early years of planning India has been depending on other countries (Particularly USA) for food grains and other food products. Over a period of time, because of planned development we could achieve self-sufficiency in food grains production. Similar is the case with the many manufactured products. Here it is necessary to note a distinction. Self reliance is different from self - sufficiency. Self-sufficiency implies isolation from other countries. In order to take full advantage of international division of labour and good political and economical international relations it is necessary to have strong international trading sector and other economic relations with other countries. Self-reliance helps in strengthening our bargaining power in international economic and political relations.

Activity - C

1. Briefly explain economic growth objective.

2. Distinguish self - reliance from self - sufficiency.

3. Large unemployment has not only adverse economic consequence but also undesirable political consequences - Explain.

7.5 PRIORITIES AND OUTLAYS OF SUCCESSIVE FIVE-YEAR PLANS

At the time of the first Five Year Plan (1951-56) India was faced with three immediate problems - Influx of refugees, severe food shortages and mounting inflation. India at that time had also to correct the disequilibrium in the economy caused by the II World War and the partition of the country. Accordingly the first plan emphasised as its immediate objectives the rehabilitation of refugees, rapid agricultural development so as to achieve food self sufficiency in the shortest possible time and control of inflation. Simultaneously the plan attempted a process of all-round balanced development which could ensure a rising national income and a steady improvement in the living standards over a period of time. The appendix Table-I gives outlays in public sector during the plan periods. During the I plan agriculture and irrigation had the largest share (31%) followed by transport and communications (27%), Social Services (22%), Power (13%) and industry (6%). It is clear from the above that agriculture and irrigation, transport and communications and social services received priority in the First Plan.

The Second Plan (1956-61) was conceived in an atmosphere of relative stability of the economy. The basic philosophy underlying the Second Plan was to give a big push to the economy through heavy industry strategy formulated by P.C. Mahalanobis. The Industrial Policy Resolution, 1956, elaborated the relevant policy aspects. The achievement of socialistic pattern of society was clearly spelt out. The Plan aimed at rapid industrialisation with particular emphasis on the development of basic and heavy industry. The appendix Table-I gives the sectoral outlays. Industrial sector received 24% allocation. As in the first plan, transport and communication received the highest allocation (28%) followed by Industry (24%), Agriculture (20%), social services (18%) and power (10%). In a developing economy right from the early stages of development there is a need for significant and sustained infrastructural developments. The first two-five year plans recognised this and invested substantial amounts on development of infrastructural sectors such as transport and communication and power.

The first two plans helped the economy to enter the Rostowian take-off stage. So Third Plan (1961-66) set as its goal the establishment of a self-reliant and self-generating economy. Performance during the second plan showed that agriculture is a constraining sector (remember here that agriculture provides the basic wage, good food and raw materials for the industry). So the third plan gave top priority to agriculture, while laying significant emphasis on basic industries. The appendix table gives public sector outlay during the third plan. As in the earlier plans the infrastructural sectors-transport and communication and power received the highest allocation (39.2%) followed by Industry (23%), Agriculture and irrigation (21%) and social services (17%). The third plan proved a thorough failure. Several exogenous and endogenous factors have contributed to this failure. Chinese aggression in 1962 and war with Pakistan in 1965, enormously increased defence needs dislocated the development efforts. Failure of monsoon except in 1964-65 was an important endogenous factor. Severe famine during 1965-66 (a bad weather year) also contributed to the poor performance during the plan period. While the Third Plan

target annual growth rate was 6%, actual growth rate fell short of this being only 2.3%. The planners became so disillusioned that government declared "Plan Holiday" for the next three years. During the three annual plans following Third Plan, the economy again faced severe crises. Economy was in the grip of recession during 1966-68. 1966-67 was another year of severe drought. The unfavourable external situation forced the government to devalue rupee in 1966 (by devaluation we mean, in a regime of fixed exchange rates increase in the rupee-price of dollar. That is, more rupees per dollar). The process of recovery started during 1967-68 and continued during the year 1968-69. During the three year period NNP registered annual compound growth rate of 3.7%. The increase in National Income resulting from good harvest was partly the outcome of the New agricultural strategy and partly the beneficial affect of good monsoon year. The improvement in supply position with regard to food grains resulted in a decline in prices. The evidence of improvement could be found in a return to stability in prices and striking improvements in the balance of payments position. The Indian economy on the eve of Fourth Plan was thus in a phase of relative economic stability.

During the Fourth Plan (1969-74) the principal objectives were growth with stability and progressive achievement of self-reliance. It was also contemplated during the plan period to ensure justice for weaker sections. "Garibi Hatao" was the prominent solgan during the period. As for the allocation of public sector outlays, agriculture and irrigation receive the highest amount (24%) followed by Industry (23%), transport and communication (20%), social services (18%) and the plan envisaged a growth rate of 5.5% per annum and per capita income growth rate of about 3 per cent per annum. The record of the progress during the fourth plan however was disappointing. The rates of growth of income and per capita income fell short of the targets (the actual growth rates of only 3.3% and 0.9%). Huge influx of refugees from Bangladesh and Indo-Pakistan conflict in 1971, successive failures on the industrial front due to power shortages, transport bottlenecks, and frequent strikes and lockouts were some of the major factors behind the economic setback during the Fourth Plan period. The price situation was alarming and the rapid rise in the prices from the middle of 1972 completely upset the calculations of the Fourth Plan projects.

The fifth Plan (1974-79) was introduced at the time when the country was suffering from a severe economic crisis arising out of a high rate of inflation fuelled by hike in oil prices since September 1973. The Fifth Plan proposed to achieve the two main objectives-removal of poverty and attainment of self-reliance through promotion of higher rate of growth, better distribution of income and a very significant step-up in the domestic rate of saving. As for the allocations of public sector outlay, industry had the highest share (26%) followed by Agriculture and irrigation (22%), power (19%), Transport and communication (18%), and social service (15%).

The annual plan (1979-80) was a disappointment. The growth rates in NNP and per capita NNP were negative.

There were two sixth plans. The Janata Sixth Plan (1978-83) was discontinued and the new Sixth Plan (1980-85) was introduced by the Congress-I government. The planners rejected the Janata approach and brought back Nehru model of the growth by aiming at a direct attack on the problem of poverty by creating conditions of an expanding economy. The Sixth Plan was launched at a time when the Indian economy was passing through a very difficult period, the high rate of inflation almost on the same pattern as the runaway inflation of 1974 and a sharp deterioration in the terms of trade directly due to the sharp increase in the price of imported oil and oil products. At that time, the stability of the Indian economy itself was in doubt, leave alone the possibility of sustained growth. Under the circumstances it is indeed satisfying that the country was able to implement the Sixth Plan successfully. The Sixth Plan was successful in achieving target growth rate. This rate could be achieved mainly because of good agricultural

performance and a rapid rate of growth in the service sector. The industrial sector performed poorly during the Sixth Plan period and the actual rate of growth in this sector was about half of what was originally targeted. The Sixth Plan had estimated the backlog of unemployment at around 12 millions in March 1980 and anticipated net addition to the labour force of the order of 34 millions during 1980-85. Thus the Sixth Plan had to generate employment of the order of 46 million persons. Attempts were made to generate additional employment through various employment-oriented, beneficiary-oriented programmes such as IRDP, NREP, RLEGP, the Training Scheme for Rural Youth for Self-Employment (TRYSEM) and the schemes for providing self-employment to educated unemployed youth.

However, the lower rate of growth in manufacturing sector during the Sixth Plan and the poor agricultural crops in the final years of the plan were responsible for significant shortfall in respect of employment target. The backlog of unemployment at the end of the Sixth Plan was estimated at 9.2 million persons, the close of the year 1984-85 (the last year of the sixth plan). Economy however was in a reasonably strong position.

As for the public sector outlay, agriculture had the highest outlay (25%) followed by industry (24%), power (20%), transport and communication (16%) and social services (15%).

With the successful completion of the Sixth Plan, it was possible in the Seventh Plan (1985-90) to move faster towards the objective of self-sustained growth with social justice. The Seventh Plan started to emphasise policies which would accelerate the growth in food grain production, increase employment opportunities and raise productivity. At this stage of development, these three important immediate objectives were central to the achievement of the goals of the Seventh Plan. Thus the focus of the Seventh Plan was on food, work and productivity.

As for the break-up of the public sector investment, the highest allocation went for the energy sector (28.6%) followed by social services (15.8%), Agriculture and rural development (13.6%), Industry and minerals (13.6%), Irrigation and flood control (7.5%), Communication (3.9%), Science & Technology and environment (1.4%), general economic services (1.3%) and general services (0.8%). Seventh Plan again was a significant success. National Income and per capita income at constant (1980-81) prices grew at an annual growth rates of 5.5% and 3.5% respectively. Index of industrial production recorded an annual compound growth rate of 8.6%. The index of agricultural production recorded an annual compound growth rate of 3.9%. Food grain production increased from 145.5 million tonnes in 1984-85 to 171 million tonnes in 1989-90.

The Eighth Plan (1992-97) (for plan resource allocation see table-1) was formulated when the country was passing through difficult circumstances during the preceding two years. The growing fiscal gap and the sudden depletion of foreign exchange reserves created a situation which put severe stress on the economic system leading to drastic curbs on imports, high rate of inflation and recession in industry. As a consequence growth rate slumped to a low level of 2.5% in 1991-92, a year previous to the beginning of the Eighth Plan. The government initiated the process of fiscal reforms as well as economic reforms with a view to provide new dynamism to the economy. The plan was to re-orient some of the development paradigms to achieve its objective of higher growth and to achieve its important goals given below :

1. Improvement in the levels of living
2. Health and education of the people
3. Full employment
4. Elimination of poverty and
5. Planned growth of population

As for the break up of public sector outlay, energy sector has the highest share (26.6%) followed by social services (18.2), transport (12.9), Industry and minerals (10.8), rural development (7.9) Irrigation & flood control (7.5), science and technology & environment (5.8), agricultural and allied activities (5.2) special area programme (1.6) and general economic services (1.4).

The Planning Commission, with Prof. Madhu Dandavate as its Deputy Chairman formulated and brought out the Ninth-Five Year Plan (1997-2002) document. Ninth five-Year Plan focuses on bettering the position of the poor. This will require not only higher rates of growth of output and employment, but an all-round human development with stress on social sectors and a thrust on eradication of poverty, minimizing economic disparities and correcting regional imbalances.

In this perspective, the approach paper to the Ninth Five Year Plan, adopted by the National Development Council had accorded priority to agriculture and rural development with a view to generating adequate productive employment and eradication of poverty, accelerating the growth rate of the economy with stable prices, ensuring food and nutritional security for all, particularly the vulnerable sections of the society, providing the basic minimum services of safe drinking water, primary health care facilities, universal primary education, shelter to all in a time bound manner, containing the growth rate of population, ensuring environmental sustainability of the development process through social mobilization and participation of people at all levels, empowerment of women and socially disadvantaged groups such as scheduled caste, ST, other BCs and minorities as agents of socio-economic change and development, promoting and developing people's participatory bodies like Panchayati Raj institutions, cooperatives and self help groups and strengthening efforts to build self-reliance. These very priorities constitute the objectives of the 9th Plan.

While the government will have to play a major role in promoting such development, there will have to be an increasing reliance on people's initiatives through institutionalised structures at the grass - root level on the basis of co-operative federalism. Because of the constraints of inadequacy of capital, large unemployment and wide technological gaps in certain sectors, Indian economy will have to harmonize the roles of state, market and cooperatives. The investment patterns will inevitably have to be a blend of public and private investments. Foreign investment will be welcome, particularly in the sectors with large technological gaps.

The Eighth Plan had identified human development as its main focus. There can be no two opinions about this being the ultimate goal of all public action including planning and development strategy. The emphasis and nuances, however, will need to vary from time to time depending upon the objective conditions of the economy and the perceptions of the people. The explicit recognition of the integral link between rapid growth and improvement in the quality of the life characterises the approach to the Ninth Plan. It is also based on the collateral recognition of the need to pursue policies which are pro-poor and are aimed towards correction of historical inequities. Thus the focus of the Ninth Plan can be described as Growth with Social Justice and Equity. The specific objectives of the Ninth plan arising from the greater reliance on market forces and the imperative for public policy and action discussed above are as follows :

- i) Priority to agriculture and rural development with a view to generating adequate productive employment and eradication of poverty.
- ii) Accelerating the growth rate of the economy with stable prices.
- iii) Ensuring food and nutritional security for all, particularly the vulnerable sections of society.
- iv) Providing the basic minimum services of safe drinking water, primary health care facilities, universal primary education, and shelter to all in a time bound manner.
- v) Controlling the growth rate of population.

- vi) Ensuring environmental sustainability of the development process through social mobilisation and participation of people at all levels.
- vii) Empowerment of women and socially disadvantaged groups such as scheduled castes, scheduled tribes and other backward classes and minorities as agents of socio-economic change and development.
- viii) Promoting and developing people's participatory institutions like Panchayati Raj institutions, cooperatives and self-help groups.
- ix) Strengthening efforts to build self reliance.

The pattern of public sector outlays is given in the appendix Table-2. To facilitate comparison we have given the percentage relating to the 8th Five Year Plan in the last column. It can be seen from the table that 25.4 per cent of total public sector outlay is for the energy sector. Social services received significant priority with 20.7% outlay under this head. Agriculture and allied activities, irrigation and flood control and rural development including special programmes received 19.8 per cent allocation. Under industry and minerals head the public sector outlay was 18.2 per cent. The public sector outlay on transport and communication was 19.8 per cent. The outlay under science, technology and environment head was 3%. General economic and other services received 3.2 per cent of total public sector outlay.

An important aspect of economic planning is mobilisation of resources for financing the plan outlays. The most difficult part of planning in any country is the mobilisation of financial resources. It is relatively easy to plan and fix targets for various sectors of the economy, but it is difficult to find sufficient finance to implement the proposed projects. The Government raises resources, by levying taxes, by floating loan within the country, and through recourse to foreign saving. If all these sources together are found inadequate, the government resorts to deficit financing. The sources of finance available to the government may broadly be divided into three categories. They are 1. domestic budgetary sources; 2. foreign borrowings and other assistance and; 3. deficit financing. The domestic budgetary resources are the funds raised by government within the country and they consist of the following :

1. Surplus from current tax and other revenues, i.e., excess of current revenues over current expenditure.
2. Contribution of public enterprises (surpluses generated in the public enterprises).
3. Mobilisation of internal private savings, through market borrowings, small saving, provident funds etc.
4. Additional resource mobilisation in the form of additional taxes and additional revenue from public enterprises.

External assistance consists of loans and grants from foreign countries, loans from internal financial institutions such as the International Monetary Fund, the World Bank, the International Development Association and the Asian Development Bank. If the domestic budgetary resources and the external assistance are found inadequate to finance the plan projects, the gap in expenditure over available resources is filled by deficit financing. This deficit is financed through borrowing from Reserve Bank of India and by using Government's accumulated cash balances.

In the above account we have given sources of finance to the public sector projects. For the private sector the following are the sources of finance :

1. The savings of the individuals (households) and of the companies. These are available to the private sector either directly or through the banking sector.
2. The private sector gets funds from public sector financial institutions such as the Industrial Finance Corporation of India and Industrial Development Bank of India.

3. The private sector may raise funds from the market through floatation of shares and debentures.
4. Private sector may get funds in the form of equity capital, foreign collaboration, subscription to equities from non-resident Indians, loans from the World Bank, borrowing from foreign banks and so on. Appendix Table-3 gives sources of finance for different plans.

It can be seen from the table that domestic budgetary resources accounted for the major part of sources of plan finance followed by external assistance and deficit financing.

Activity - D

1. Explain the priorities during the first six five year plans.

2. On the basis of public sector plan outlays, indicate the sector which received priority attention during different plans.

3. Explain the sources of finance for public sector and the private sector.

7.6 ECONOMIC GROWTH RECORD DURING PLANNING ERA

Table-7.1 gives growth record (NNP and per capita NNP growth rates) during the planning era. It can be seen from the table that during the first two plan periods the growth rate of National Income and per capita income were satisfactory. But growth rates decelerated during the third plan period. The National Income in real terms grew only at the rate of 2.3 per cent, the per capita income growth rate being only 0.1 per cent. During the subsequent three annual plans growth rates picked up and stood at 3.7 per cent and 1.4 per cent. Again there was deceleration in growth rates during the fourth plan, the growth rates being 3.3 per cent and 9.9 per cent. The growth rates accelerated during the fifth plan and stood at 4.9 per cent and 2.6 per cent. The subsequent annual plan (1979-80) was a miserable failure, the growth rates turned negative (-) 6.0 per cent and (-) 8.2 per cent. During the sixth plan and seventh plan, the growth rates were substantially high, the highest recorded until then. There was again deceleration in growth rates during the two annual plans (1990-92), the growth rates in national

income and per capita income were only 2.5 per cent and 0.4 per cent respectively. The subsequent Eighth Plan performance was substantial improvement over the previous two years. The growth rates were 6.8 per cent and 4.9 per cent.

It is clear from the above account that the planned development received periodic setbacks and growth was not a smooth phenomenon. From the mid 1960s until 1980s deceleration in growth rates occurred. The deceleration of growth thesis demonstrated by Brahmananda and others can be seen from the lower growth rates of NNP and per capita NNP after 1961 compared with the period prior to 1961. But the growth rates picked up significantly during the decade of 1980's.

TABLE - 7.1

ANNUAL COMPOUND GROWTH RATE

(of NNP at factor cost at constant 1980-81 prices upto (1992-93) and from 1992-93 onwards at constant (1993-94) prices)

	NNP at Constant Prices	Per Capita Net National Product at Constant Price
First Plan (1951-56)	3.6	1.7
Second Plan (1956-61)	3.9	1.9
Third Plan (1961-66)	2.3	0.1
Three Annual Plans (1966-69)	3.7	1.4
Fourth Plan (1969-74)	3.3	0.9
Fifth Plan (1974-79)	4.9	2.6
Annual Plan (1979-80)	(-6.0)	(-8.2)
Sixth Plan (1980-85)	5.4	3.2
Seventh Plan (1985-90)	5.8	3.6
Two Annual Plans (1990-92)	2.5	0.4
Eighth Plan (1992-97)	6.8	4.9

7.7 FACTORS RESPONSIBLE FOR PERIODIC SETBACKS DURING THE PLANNING ERA

Several factors explain these fluctuations in respect of growth experience during the period covered by Table-7.1. Fluctuating weather conditions (alternating droughts and floods and periodic unfavourable monsoons), unfavourable increase in capital - output ratio, balance of payments problems and the consequent foreign exchange crises, war with China and Pakistan dislocating the development efforts, international transmission of inflation through foreign trade, particularly oil price hikes during early 1970's and later, gulf crisis, collapse of the Soviet Union and structural imbalances which have developed in the economy as development proceeded were some of the major factors to be noted in this connection.

Activity - E

1. Explain the factors responsible for thorough failure of the Third Plan.

2. 1980's decade was a high growth period - Explain.

3. Explain the factors responsible for periodic set backs in India's growth experience.

7.8 NEW ECONOMIC POLICY (1991) AND THE FUTURE OF PLANNING IN INDIA

The new government which assumed office in June 1991 faced a serious economic crisis. The balance of payments situation was severely adverse, with foreign exchange reserves barely enough for two weeks of imports. International confidence reached such a low point that access to commercial lending was almost closed and NRI deposits were being withdrawn at a rapid pace. Industrial growth had turned negative because of severe import compression and inflation was accelerating. Between 1989-90 and 1990-91 inflation rate went up from 7.4 per cent to 10.3 per cent. Behind the crisis were a few major changes witnessed during the 1980's. The changes in the patterns of financing investment is one major change. There was an increasing reliance on foreign capital in 1980's. In the 1970s domestic investment was financed largely by domestic saving. The trend was reversed in the 1980's and by 1989-90 net capital inflow accounted for as much as 10 percent of domestic investment. Besides the change in magnitude, the composition of foreign borrowing also changed during the 1980s. In the 1970s India's foreign borrowing consisted of mainly long-term institutional loans provided by foreign governments and international financial agencies such as International Monetary Fund and the World Bank at concessional interest rates. In the 1980's the share of both long-term institutional finance and concessional loans declined and that of short term commercial borrowing increased. The share of commercial borrowing in total external debt rose from 19 percent in 1985-86 to 26 per cent in 1990-91.

The second major change occurred in the financing of the public sector investment. In 1976-77 public saving financed 49 per cent of gross public investment. In 1981-82, the ratio came down to 43 per cent and in 1989-90 the ratio stood at 16 per cent. More than four-fifths of

public investment, thus, was financed by borrowing from domestic private and external sectors. In addition, government was borrowing to finance current expenditure.

Another change that occurred in 1980's was in respect of inflation. In the earlier years seasonal factors were playing an important part. Inflation rate varied between good and bad agricultural years. Typically in a good agricultural year inflation rate either stabilized or fell and in a bad agricultural year it increased. But this pattern disappeared in the 1980's. This irreversibility of general price level has set in a positive price expectations, which was generally subdued in earlier years.

Before the implementation of the new policy package, economic liberalisation being its significant feature, there was a very serious danger that the positive price expectations might soon turn into hyper inflation expectations through the combined effect to fiscal and balance of payments crisis.

Faced with this grim situation the newly installed government at the centre in June 1991 has announced its decision to make a structural adjustment in the overall economic policy pursued during the post-Independence period. Besides macro-economic stabilization and fiscal adjustment, the government intended to increase the efficient and international competitiveness of industrial production by encouraging foreign investment and foreign technology. Simultaneously, the government has decided to remove barriers to entry and limits on growth in the size of firms in the domestic economy. Competition and private enterprise would be encouraged in the domestic market so that there are adequate incentives for raising productivity, improving resource use and efficiency and reducing costs. The new policy package also has sought, along with domestic competition, to remove barriers to foreign trade and capital flows. The role of public sector will be confined to infrastructure and high technology sectors.

With the decision to reduce the scope and extent of public sector and economic liberalization with emphasis on giving greater scope for free enterprise to flourish in the economy, the nature of planning as well as the development strategy will have to change. The economic reform process initiated in 1980's took a firm shape with the announcement of new policy package in 1991. The Ninth Plan document gives a detailed account of these. We note these changes from the Ninth Plan document.

The Planning Commission believes that the principal task of planning in a federal system is to evolve a shared vision of and a shared commitment to the national objectives and the development strategy not only in the government at all levels but also among all other economic agents. No development strategy can be successful unless each component of the economy works towards a common purpose with the fuller realization of the role that has to be played within an overall structure of responsibilities. The principal function of the approach to the Ninth Plan is not only to articulate such a shared vision but also to ensure shared commitments.

Based on such a shared vision the principal task during the Ninth Plan is to build on the success of the eight plans, while tackling the problems that have emerged, particularly in areas such as capital formation in agriculture, living standards of the poor, infrastructure, social sector, regional disparity and fiscal deficits. Despite the considerable progress that has been made by the Indian economy in both economic and social spheres, the development task is far from complete and resources continue to be limited. Moreover, as has been indicated, the Indian economy is still vulnerable and the operation of a more open economic system has to be tempered by judicious public interventions to ensure that these vulnerabilities are gradually overcome.

Recognising the federal nature of the Indian system, the planning process has to develop a common policy stance which would be adopted both by the Centre and the States. The role of planning would therefore involve considerable degree of policy coordination between the Centre and the States, between the States and the Sub-State level tiers of government.

In light of the emerging situation, sectoral investment planning continues to form an important component of the planning process. Individuals and entrepreneurs are frequently unable to assess the areas of opportunities and to anticipate likely problems. Investment planning is a methodology to bridge this gap. The planning process also needs to take stock of the resources for development and to indicate methods by which these resources can be augmented in a sustained manner. Since planning is done for the entire nation, the strategies for resources augmentation need to cover not only the government at all levels but also those which would be available to other sections of people.

The other principal task of planning, particularly in a market oriented economy is to identify the areas of emerging vulnerabilities and to suggest measures to address them. Although the specific policies would need to be worked out by the concerned ministries or the states, the broad directions would have to be provided by the planning system. Unless such problem areas are placed within the wider macro - economic context, short-run fire fighting measures can lead the economy in undesirable directions.

With the reduction in the instruments available to government in controlling economic matter and the greater degree of uncertainties that are present in any market based system, the methodology of planning will have to change if it is to retain its relevance. The Eighth five year plan had explicitly indicated a shift from directive to largely indicative plan. There is considerable variance in the interpretation of this term. The 9th Plan is based on a more specific modality of planning which involves working out of a consistent and desirable development path, the identification of emerging trends and deriving policy measures to bring about a confluence between the two. The planning process today, therefore, focuses on planning for policy so that the signals that are sent to the economic system induce the various economic agents to behave in a manner which is consistent with the national objectives.

The plan document also explains the changes in development strategies. The gradual shift in development strategy that has occurred since the early 1980's in India is now at a stage where it needs to be articulated fully and unambiguously. Although India has always had a vibrant private sector and a functioning market economy, the role of the Government has been dominant, not only as a significant investor and producer of goods and services in its own right, but also as an arbiter of the actions of the private sector. The former's role will have to continue in the foreseeable future, since the economy is still not at a stage where the most pressing needs of public goods and services have been met in adequate measure. Nor for that matter are the private sector and the people's organizations at a stage where they can shoulder the responsibilities of meeting these needs. In so far as the latter's role is concerned, it too will have to continue, but its manner and content will need to change. In the development strategy of earlier years, government intervention was overly focused on guidance through prevention. As a consequence there was insufficient room for market signals to determine the course of private behaviour. Greater reliance on market forces and people's initiatives implies that the focus of government action will have to shift towards evolving transparent and unambiguous policies with limited scope for discretionary action, greater decentralization and improved monitoring and enforcement systems.

Thus, with the reduced role of state in economic matters and market friendly policies over a period of time, planning becomes more and more indicative. Government policy will seek to create conducive environment for private economic agencies to operate in such away that the efficiency goal as well as Social Justice goal are achieved.

Activity - F

1. Explain the major components of New Economic Policy.

2. Explain changed nature of economic planning in India.

7.9 SUMMARY

In this unit the meaning of planning is explained. The factors which influenced introduction of planning in India received attention. Different aspects of Five Year Plans are explained with statistical data. The economic growth record during the planning era, the factors responsible for periodic setbacks during the economic growth process and the future of planning in India are explained in the unit.

7.10 SELF - ASSESSMENT TEST

1. Explain the objectives of the Ninth Plan.
2. Explain the achievements and failures of economic planning in India.

7.11 FURTHER READINGS

1. Ruddar Dutt and KPM Sundaram, Indian Economy, New Delhi, S. Chand & Co., 1999.
2. Government of India Economic Survey, for different years,
3. Government of India, Planning Commission, Ninth Five Year Plan 1997-2002.
4. V. Lakshmana Rao, Essays on Indian Economy, New Delhi : Ashish Publishing House.

APPENDIX TABLES

TABLE - I

(Rs. in Crores)

	I Plan Outlay	II Plan Outlay	III Plan Outlay
I. TOTAL OUTLAY	3870	7900	11600
a) Private Sector Outlay	1800	3100	4100
b) Public Sector Outlay	2070	4800	7500
II. Actual Public Sector Outlay	1960	4672	8577
Breakup of Public Sector			
Agriculture and Irrigation	600 (31%)	950 (20%)	1750 (21%)
Power	260 (12%)	440 (10%)	1250 (14%)
Industry	120 (06%)	1080 (24%)	1970 (23%)
Transport and Communication	520 (27%)	1300 (28%)	2120 (25%)
Social Services	460 (22%)	830 (18%)	1490 (17%)
TOTAL	1960 (100%)	4600 (100%)	8580 (100%)

	IV Plan Outlay	V Plan Outlay	VI Plan Outlay
I. TOTAL OUTLAY	24880	53410	158710
a) Private Sector Outlay	8980	16160	61210
b) Public Sector Outlay	15990	37250	97500
II. Actual Public Sector Outlay	15779	39426	110967
Breakup of Public Sector			
Agriculture and Irrigation	3810 (24%)	8650 (19%)	24700 (25%)
Power	2450 (15%)	7360 (19%)	19370 (20%)
Industry	3630 (23%)	10290 (26%)	23050 (24%)
Transport and Communication	3240 (20%)	6920 (18%)	15540 (16%)
Social Services	2770 (18%)	6100 (15%)	14840 (15%)
TOTAL	15900 (100%)	39320 (100%)	97500 (100%)

VII Plan outlay	
I. TOTAL OUTLAY	322366
a) Private Sector Outlay	154218 (47.8%)
b) Public Sector Outlay	168148 (52.2%)
II. Actual Public Sector Outlay	222169
Breakup of Public Sector	
Agriculture and Irrigation	
1. Agriculture and Rural Development	30317 (13.6%)
2. Irrigation and Flood Control	16719 (7.5%)
3. Energy	63615 (28.6%)
4. Industry - Minerals	30052 (13.5%)
5. Transport	30140 (13.6%)
6. Communication	8664 (3.9%)
7. Science - Technology	3086 (1.4%)
8. General Economic Services	2862 (1.3%)
9. Social Services	35037 (15.8%)
10. General Services	1677 (0.8%)
TOTAL	222169 (100%)

(Rs. in Crores)

	VIII Plan 1992-97		Annual Plan 1997-98 (R.E)	Annual Plan 1998-99 (B.E)
I. TOTAL OUTLAY	798000		---	---
a) Private Sector Outlay	361000 (45.2)		---	---
b) Public Sector Outlay	437000 (54.8)		---	---
II. Actual Public Sector Outlay	434000		---	---
1. Agriculture and Allied Activities	22467 (5.8)		6221.5	3864.1
2. Rural Development	34425 (7.9)		101621.5	5881.7
3. Special Area Programmes	6750 (1.6)		840.0	0.0
4. Irrigation & Flood Control	32525 (7.5)		10637.5	374.6
5. Energy	115561 (26.6)		32568.5	30081.9
6. Industry and Minerals	46922 (10.8)		12522.4	11550.9
7. Transport	55926 (12.9)		18639.6	16185.9
8. Communication	25110 (5.8)		11143.5	14877.8
9. Science, Technology & Environment	9047 (2.1)		2118.0	2766.2
10. Social Services	79012 (18.2)		30938.6	18310.1
11. General Economic Services	6360 (1.4)		1972.9	1010.9
TOTAL	434100 (100.0)		139625.9	105187.2

TABLE-2
NINTH FIVE YEAR PLAN 1997-2002
Proposed Public Sector Outlay by Major Heads of Development

Sector	Centre	Percent	States	Percent	Total	9th plan	8th plan
1. Agriculture & Allied	13017	2.6	23641	6.4	36658	4.2	12.7
2. Irrigation and Flood Control	2546	0.5	55189	14.9	57735	6.6	---
3. Rural Development	46077	9.1	28865	7.8	74942	8.6	7.9
4. Special Programme	---	---	3790	1.0	3790	0.4	1.5
5. Energy	150746	29.8	71227	19.3	221973	25.4	26.6
6. Industry & Minerals	57677	11.4	14007	3.8	71684	8.2	10.8
7. Transport	85149	16.9	39039	10.6	124188	14.2	12.9
8. Communication	48759	9.7	32	0.0	48791	5.6	5.8
9. Science, Technology & Environment	23217	4.6	3126	0.8	26343	3.0	2.1
10. General Economic Services	6946	1.4	8623	2.3	15569	1.8	1.5
11. General Services**	862	0.2	11534	3.1	12396	1.4	---
12. Social Service	70165	13.9	110766	29.9	180931	20.7	18.2
TOTAL	505161	100.0	369839	100.0	875000	100.0	100.0

TABLE-3
SOURCES OF FINANCE FOR FIVE YEAR PLANS

Plans	Domestic Budgetary Resource		External Assistance		Deficit financing		TOTAL	
	Amount (Rs. crores)	%	Amount (Rs. Crores)	%	Amount (Rs. Crores)	%	Amount (Rs. Crores)	%
First Plan	1440	73	190	10	330	17	1960	100
Second Plan	2560	56	1090	24	950	20	4600	100
Third Plan	5090	59	2390	28	1150	13	8630	100
Fourth Plan	12010	74	2090	13	2060	13	16160	100
Fifth Plan	32120	82	5830	15	5830	3	39300	100
Sixth Plan	86610	78	8530	8	15680	14	110820	100
Seventh Plan*	134190	75	16124	9	28256	16	178870	100
Eighth Plan**	385400	89	28700	7	20000	4	434100	100

* Estimates

** Projections

BRAOU

UNIT- 8 : STRUCTURAL DIMENSIONS OF INDIAN ECONOMY

Objectives

After reading this unit, you will be able to :

- Understand the importance of economic growth and economic development;
- Examine and analyze in detail India's economic growth experience;
- Identify and explain structural changes that have been taking place in the economy, and
- Analyse the current economic situation in India.

Structure

- 8.1 Introduction
- 8.2 Economic Growth and Development
- 8.3 India's Economic Growth and Development Experience
- 8.4 Important Structural Changes in the Economy
- 8.5 Trends and Components in India's Saving and Investment
- 8.6 Trends in Monetary Factors and Price Level
- 8.7 Other Relevant Structural Dimensions
- 8.8 Population and Other Demographic Trends and Structure
- 8.9 Summary
- 8.10 Self-Assessment Test
- 8.11 Further Readings

8.1 INTRODUCTION

The purpose of gathering and analysing data (mainly from official sources) is to obtain a clear understanding of major economic trends and structural changes in the economy. This understanding enables us to make a quantitative assessment of the economic environment of business enterprises.

A thorough empirical knowledge of economic trends and structural changes helps a firm to plan out a business strategy and policy to cope with the short-run and long - changes of business environment. This unit attempts to give the details about the relevant economic trends and to discuss structural changes, it then examines the implications of growth and structural changes that have occurred. It also analyses the current economic trends, and discusses the impact of economic environment on business management.

While studying this unit you may have to refer to additional statistical materials again and again. Of course you are not expected to get by heart the details of also such data. You should only take note of these trends which are useful to the analysis of the environment surrounding your own business or business you are interested in.

8.2 ECONOMIC GROWTH AND DEVELOPMENT

It is possible and necessary to make a distinction between economic growth and economic development. Though in common parlance as well as in economic literature the two terms are some times used as synonyms, they have different connotations or meanings.

Economic growth means growth in output of different goods and services, while economic development connotes both more output and changes in the technical and institutional arrangements by which it is produced and distributed and also social changes which accompany growth.

Economic growth involves not only more output derived from the use of large amount of inputs but also from improved efficiency, that is an increase in productivity. Increase in productivity means increase in output per unit of input. The economic history of the Western economies revealed that productivity improvements played an important part in the growth of those economies.

Economic development goes beyond this to encompass several dimensions of human resource development and social changes conducive for rapid economic growth. The attitudinal and behavioral changes among people also play a significant role in this connection. For example, Jan Tinbergen suggests five human qualities which are conducive to economic development. They are (1) an interest in material well being, (2) an interest in techniques and in innovation, (3) an ability to look ahead and willingness to take risks, (4) perseverance and (5) an ability to collaborate with other people and to observe certain rules.

Development economics tells us that the level and rate of economic growth depend on natural resources, physical capital accumulation, human resource development and technological progress provided the socio-cultural environment is favourable to growth. Thus the socio-cultural environment within which economic activity is organized assumes an important role. Arthur Lewis discusses at length the role of social and economic institutions in the process of economic growth. In Rostow's view, the behaviour patterns of people relevant for economic development can be summed up in six propensities, "the propensity to develop fundamental science, to apply science to economic ends, accept possibilities of innovation, to seek material advance, to consume and to have children". According to him these propensities represent aspects of social behaviour which determine, given productive resources, the level and rate of growth of output. Some economists abstract from the socio-cultural factors by treating them as exogenously given, while others argue that it is necessary to supplement pure economic analysis of development problem with the study of socio-cultural factors. For example, Hagen makes out a strong case for making the analysis of psychological propensities and social structure an integral part of any study of economic development. Simon Kuznets highlights the role of human resources in economic development when he says, "the major capital stock of an industrially advanced nation is not its physical equipment, it is the body of knowledge amassed from tested findings and discoveries of empirical science and the capacity and training of its population to use the knowledge effectively".

As in the case of human beings, to stress on growth involves focus on height or weight (national income), while emphasis on development draws attention to changes in attitudes and functional capacities - responding to challenges or learning capacity (ability of the economy to adapt).

Conceptual and Measurement Background

Now let us learn more about economic growth. Economic growth may be defined as a significant and sustained rise in per capita real income. One must distinguish the "level" from the "rate" of economic growth, although these two concepts are obviously related. The level of economic growth of a country is measured by the size of national (or per capita) real income.

The percentage change in this level over a year is the annual rate of growth. That is, if we denote the levels of real income in two consecutive years by y_1 and y_2 and g as the rate of growth (expressed in percentage terms), then

$$g = \frac{y_2 - y_1}{y_1} \times 100$$

Per capita real income is supposed to be a satisfactory measure of level of economic growth of a country. It takes into account changes in national income, population and price level. In this connection the following relationships are very useful :

* Real National Income =

$$(\text{National Income at Current Price} / \text{General Price Index}) \times 100$$

In symbols

$$y = (y/p) \times 100$$

$$\text{* Per Capita Real Income} = \frac{\text{Real National Income}}{\text{Population}}$$

In symbols

$$y_p = y / N$$

* Real Income Growth Rate =

Growth Rate of National Income at Current Prices - Inflation Rate

$$\text{In symbols } \bar{y} = \bar{y} - \bar{p}$$

Bar over a symbol signifies rate of growth of that variable.

* Per Capita Real Income Growth Rate =

Real Income Growth Rate - Population Growth Rate

$$\text{In symbols } \bar{y}_p = \bar{y} - \bar{N}$$

Inter-temporal (over a period of time) and international and inter-regional (over space) comparisons of economic growth can be made. For the first (for example a country's economic growth experience over a period of time), we use time series data. For the second, we use cross-section data relating to different countries or different regions within a country.

When you are interested in comparisons of levels of living, the per capita consumption of essential goods and services, per capita production and availability of certain items, (for ex: electricity consumption per capita), availability of civic amenities and so on.

As we noted before, productivity improvements are an important aspect of economic growth process. Labour productivity is a familiar "partial" productivity concept. It is a partial concept because it relates output measure to a single factor input namely labour input. Total factor productivity, however, is a relationship between output and weighted combination of factor inputs. Thus while partial productivity ratios are ratios between net output and individual factor input, total productivity is a ratio between net output and a weighted combination of relevant factor inputs (usually labour and capital). The simple nature of labour productivity concept and corresponding measures have come to be widely used by economists. Labour productivity (net output per worker, or per man-hour) improvements can be interpreted (with the necessary qualifications and with the understanding of its limitations) as an indicator of economic efficiency. Further more, improvements in labour productivity also signify improvement in living standards of people.

If we denote real national income by y , population by N , working force by W , then we can rewrite the formula for real per capita income y_p in the following way:

$$y_p = \frac{y}{N} = \frac{y}{W} \cdot \frac{W}{N}$$

The above formula suggests that the level of per capita real income (y_p) is the product of labour participation rate [W/N] and real income per worker [y/W]. From the above equation it is clear that given the labour force participation rate [W/N], the change in labour productivity [y/W] reflects the growth trend in per capita income. An increase in labour productivity indicates economic growth, a decrease in the labour productivity suggests economic deterioration and constancy of labour productivity signifies stagnation of the economy.

The labour productivity measure of economic growth is of crucial significance for management in developing economies. In capital-scare developing economies there is undoubtedly a need for optimum utilisation of plant and machinery. The preceding argument suggests a more urgent need for efficient and optimum utilisation of labour in a developing country with abundant labor. The task of management in this context is to maintain an industrial relations climate such that labour productivity can register rapid improvements. Thus **“productivity movement”** or **“productivity revolution”** is a key to improve economic environment of developing countries.

Economic Development

As noted before, economic development is a broader concept than economic growth. As economies grow in terms of national and per capita real income levels, certain structural changes accompany the process of growth. Broadly speaking, the growth in income and the structural changes together constitute economic development. The structural changes which are quite fundamental in character are inherent in the process of economic growth.

The upward trend in per capita real income (that is, economic growth) implies, given the labour force participation rate, a rise in output per worker or labour productivity. An increase in labour productivity cannot result without capital accumulation and fundamental changes in the production function (functional relationship between flows of inputs and corresponding flows of output of the economy). A progressive shift in the production function is the direct outcome of technological advancement and science is the base of modern technology.

As science and technology advance, innovations (new products, new production processes and methods, new markets etc.) take place. Such process of growth (scientific progress, inventions and innovations) cannot be economically sustained for long unless it increases the productivity of labour.

The increase in the flow of material goods and service must also be absorbed, otherwise the process of growth gets obstructed by market limitation. In other words, the changes in production structure must be synchronised and balanced with the changes in the consumption structure. The structure of society's wants and preference (in short, structure of demand) must change in such a way as to induce or assist changes in production and productivity and thereby to accommodate the change in science and technology. Similarly, the progressive development through science and technology cannot come about unless the society manages to generate capital formation (through savings and investments) and finance research and development of science. (The present day developing countries can supplement their scientific research efforts with science and technology transferred from more developed countries). Thus we find that during the process of economic growth, an economy experiences manifold changes in its structure; social, political and economic. For an understanding of the changing economic environment in

developing country, we may examine specifically the nature of some of the structural changes which are economic in character.

Structure of National Output

Studies of economic development of many present day "more developed countries" (a phrase suggested by Evert E. Hagen) like the U.S.A., the United Kingdom, and Japan suggest that a change in the structure of national output is a concomitant feature of economic growth. As an economy grows, on the one hand, the level of national income increases, and on the other, composition of national income changes. The percentage contribution of agriculture to gross domestic product declines and the percentage contributions of industry and services to gross domestic product increase. This reflects positive income elasticity of demand for non-agricultural output. This means that a given percentage increase in the income will result in higher percentage increases in demand for non-agricultural output. As the ratio of non-agricultural to agricultural output increases during the period of economic growth, labour productivity increases in both agricultural and non agricultural sectors. The rate of growth of non-agricultural output is observed to be faster than that of non-agricultural employment and therefore, the labour productivity (output per worker), in mining, manufacturing and services registers improvement during the process of economic growth.

Structure of Investment and Capital Formation

A change in the structure of investment and capital formation is another development during the process of economic growth and development. With industrialisation and consequent urbanisation the structure of industries changes. Capital and producer goods industries grow in importance, and consumer goods industries decline in relative importance. In developing countries (particularly those with planning) in the initial stages of development, resources are deliberately shifted from consumption goods to capital goods. Thus the investment structure changes. The investment in human capital (education and health) and social overhead capital (like irrigation, transport, etc) increases very rapidly in the early stage of development when the infrastructure of development is laid strongly. Similarly, in the early stages of development, the dependence on foreign capital (aid, loans and grants) and foreign technology may also be very high. This means that the ratio of gross (and net) domestic capital formation to gross (and net) national capital formation is affected. This points out that different capital formation proportions reflect the nature and tempo of economic growth.

While on the subject of capital formation, we may refer to an important determinant of the rate of economic growth. This determinant is the capital-output ratio. We distinguish average capital - output ratio from marginal or incremental capital output ratio. Incremental capital output ratio (ICOR) is the additional capital required to increase output by one more unit. The following is the basic economic growth rate (g) equation.

$$g = \frac{\text{Rate of Investment}}{\text{ICOR}}$$

In the above equation g is growth rate and ICOR is incremental capital-output ratio. In macro-economic planning process as well as micro-level management decisions, this ratio proves very useful. Consider, for example, the macro-economic planning process. If a planning agency wants to achieve an annual growth rate of 5% (growth rate of national income) and if the incremental capital output ratio is 4, then what should be the annual rate of investment? The above equation helps us in answering the question.

$$g = \frac{\text{Rate of Investment}}{\text{ICOR}}$$

In our example, $g = 5\%$ and $ICOR = 4$

$$5\% = \frac{\text{Rate of Investment}}{ICOR} = \frac{\text{Rate of Investment}}{4}$$

Rearranging the terms we get

$$\text{Rate of Investment} = 5\% \times 4 = 20\%$$

Changes in the capital output ratio is a dimension of economic growth and development process.

Structure of Consumption

The upward trend in per capita income (economic growth in short) which initiates and accelerates changes in production, employment, factor proportions, skill and capital formation directly brings about a change in the structure of consumption. As income changes, the pattern of income distribution (between regions, between sectors and between persons) also changes. This is backed up by changes in relative price structure of the economy, the domestic terms of trade between agricultural and non-agricultural sectors change. It is through the interaction of all these factors that the structure of consumption and the standard of living undergoes a fundamental change reflecting changes in social values, beliefs and consumer preferences.

Finally with changes in the structure of employment, production, income distribution and consumption, there comes naturally, a change in the structure of foreign trade. In the initial stages of development, an economy may have to import metals and machinery for modernisation and industrialization. But as the industrialization proceeds with economic growth, the pattern of exports and imports change. Structure of foreign trade, in short, changes (a separate block in this course is devoted to the external sector) as economy changes from primary commodity exporting to export of manufactures.

In the next section, we give an outline of the Indian economic growth experience. The remaining sections deal with major structural dimensions of India's economic development experience.

Activity - A

1. If national income at current prices in 1992-93 is Rs. 546023 crores, and wholesale price index for the year was 228.7, find out national income at constant (1980-81) prices or real national income.

2. Explain any two structural changes which accompany economic development.

3. If target growth rate is 9% and ICOR is 4, find out the required rate of investment ?

Activity - B

With the help of the latest Economic Survey of the Government of India formulate tables about 1. Employment in the organised sector, 2. Index numbers of agricultural production for the years 1990-91 to 1997-98 and 3. Index numbers of yield of food grains crops for the period 1990-91 to 1997-98.

8.3 INDIA'S ECONOMIC GROWTH AND DEVELOPMENT EXPERIENCE

In this section we explain Indian growth experience. The interest is to map the broad contours of the Indian growth experience. Over the period 1950-51 to 1995-96, the NNP at factor cost at constant (1980-81) prices recorded an average annual growth rate of 3.97 percent, while per capita NNP in real terms grew at an annual rate of 1.87 per cent. Thus during the period 1950-51 to 1995-96, the population recorded roughly a growth rate of 2.1 per cent. The per capita NNP at constant (1980-81) prices increased from Rs. 1126 in 1950-51 to Rs. 2573.2 in 1995-96. Thus during the 46 year period the increase in per capita income was approximately 2.28 times. Going by the overall annual growth rate in per capita income, one can say that while the Indian growth experience over the period was significant, the growth recorded was not sufficient to solve the three basic economic problems namely poverty, unemployment and economic inequalities. It is appropriate here to note growth rates for recent years. During the year 1996-97 the growth rates of national income and per capita income at constant (1993-94) prices were 8.2 per cent and 6.3 per cent respectively during the year 1997-98, quick estimates indicate that real national income and per capita income growth rates were 4.8 per cent and 3% respectively. Thus there took place deceleration in growth rates.

Both income and per capita income fluctuated significantly. National income in real terms recorded negative growth rates in five years. These were 1957-58, 1965-66, 1972-73, 1979-80 and 1991-92. If we use three per cent growth rate as the cut-off point, the country experienced below 3 per cent real growth rate in 12 years. Leaving aside the five years when national income in real terms registered negative growth rates, the country experienced more than 3 per cent growth rate in 29 out of 41 years of positive national income growth rate.

Per capita income in real terms recorded negative growth rate in 11 out of 46 years. Population growth rate thus was an important factor behind poor performance of the Indian economy in terms of per capita income growth in real terms.

The above account shows that both income and per capita income fluctuated significantly. Several factors explain fluctuations in respect of growth experience during the period 1950-51 to 1995-96. Fluctuations in weather conditions (alternating droughts and floods and periodic failure of monsoon), unfavourable increases in the aggregate capital output ratio, balance of payments problems and the consequent foreign exchanges. Crises, wars with China and Pakistan dislocating the development efforts, international transmission of inflation through foreign trade, exogenous shocks such as oil price hikes engineered by OPEC during early part of 1970's and

later, the structural imbalances which have developed in the economy as development proceeded and the political instability during some years were some of the factors to be noted in this connection.

Economic Development - India in the World Context

We are living in a world of extreme inequalities. World Bank in its World Development Report (an annual publication) classified the economies into 3 categories (based on GNP per capita). Countries with GNP per capita lower than \$765 are the low-income economies (LIEs), those with \$766 - 9385 are the middle income economies (MIEs) and countries with more than \$9385 are the High Income Economies (HIEs). In 1995, the low income economies were supporting 56.1 per cent of world population with only 4.9 per cent of world income. India, one of the low-income countries, was supporting 16.4 per cent of world population with only 1.2 per cent of the world income. The middle income economies were supporting 28.0 per cent of world population with 14.5 per cent of world income. The rich countries (HIEs) were enjoying in 1995, 80.7 per cent of world income supporting 15.9 per cent of world population.

India is one of the low-income economies. With land area of 3288 thousands of square kilometers, India in mid - 1995 was supporting 929.4 million population. The density of population (population per square kilometre) in 1995 in India was 283, significantly higher than the average for HIEs (28), the world average being 42. High population pressure has been a major demographic problem of India.

In 1995, the latest year for which comparable data are available, the per capita GNP of India was \$340, the average for the LIEs being \$430. While the per capita GNP growth rate during 1985-95 for the LIEs was 3.8 per cent whereas it was 3.2 per cent in the case of India. As for the GDP growth rate of India during the period 1980-90, it was 5.8 per cent slightly lower than the average for the LIEs (6.0%). During the subsequent 1990-95 period the growth of Indian GDP decreased to 4.6 per cent, while the average for the LIEs increased to 6.8 per cent. Thus although India experienced significant economic growth during the period 1980-95, the Indian economic performance as reflected in the GDP growth rates, fell short of the average for the LIEs.

What was the experience of India in respect of inflation which has become global phenomenon since 1970s? During the period 1970-80, the inflation rate experienced by India was 8.4 per cent, which was slightly higher than the average inflation rate experienced by the LIEs (8.2 per cent). During the same period, as noted before, the GDP growth rate experienced by India was 3.4 per cent. During the subsequent 1980-91 period inflation rate registered a slight decrease, while the GDP growth rate increased from 3.4 per cent to 5.3 per cent. In respect of LIEs, while inflation rate increased from 8.2 per cent during 1970-80 to 12.6 per cent during 1980-91, GDP growth rate increased from 4.5 per cent to 6 per cent. The Indian as well as LIEs experience during the period 1970-91 suggests that inflation rates and economic growth rates do not show any definite relationship. It is to be noted here that international country cross section statistical studies also did not reveal any firm relationship between inflation rates and economic growth performance of countries.

Usually low life expectancy is associated with low income levels of countries. Although in India life expectancy at birth has been increasing gradually it is still lower than the average for the LIEs. In 1995, the life expectancy at birth in India was 62 years, while average for the LIEs and HIEs were 63 years and 77 years respectively. Another important demographic indicator of economic development is infant mortality rate (deaths per thousand of live births). The infant mortality rate in India has been declining during the recent decades. It declined from 137 in 1970 to 68 in 1995. The average for the LIEs in 1995 was 69. Relatively low life expectancy and significant infant mortality rate thus constitute another dimension of the Indian economic and demographic experience.

Activity - C

1. Explain the basic features of the Indian economy.

2. What are the factors responsible for periodic setbacks in the growth experience of India ?

8.4 IMPORTANT STRUCTURAL CHANGES IN THE ECONOMY

Economic growth and development are accompanied by important structural changes in the economy. The structural changes are evident in the form of shifts in the sectorial composition of income and employment, diversification in economic activities and gradual transformation of a feudal and colonial economy into a modern industrial economy. In this section we deal with basic structural changes that have taken place in the economy during the planning era.

For analytical as well as descriptive purposes economists divide an economy into three sectors, namely primary sector, secondary sector and tertiary or service sector. Primary sector includes. 1. Agriculture, 2. Forestry and logging, 3. Fishing and 4. Mining and quarrying. The secondary sector is comprised of- 1. Manufacturing (registered and unregistered), 2. Construction and 3. Electricity, gas and water supply. The tertiary sector is comprised of 1. Transport, storage and communications, 2. Trade, hotels, and restaurants, 3. Finance and real estate and 4. Community and personal services.

While the share of primary sector in Gross Domestic Product (GDP) fell from 54.91 per cent during the First plan period to 31.0 per cent during the 8th Plan period, the share of secondary sector increased from 11.88 per cent to 27.39 per cent during same period. The share of tertiary or service sector increased from 28.32 per cent to 41.61 per cent between the First Plan and the Eighth Plan. The expansion of the service sector has not only been conducive for employment generation but also for better efficiency of the system and better quality of life. Thus significant structural change has taken place in the Indian economy during the period 1951 to 1997, when we go by sectorial distribution of national income. So by income criterion structural change in the Indian economy has been very significant.

Now let us consider structural change by employment criterion. It is generally accepted that one of the structural changes that occur in the source of economic development is a progressive shift of labour from agriculture and allied activities to secondary and tertiary sectors. Studies based on historical data have amply demonstrated the validity of this Fisher-Clark thesis. While this broad trend in sectorial reallocation of labour as development proceeded is thus firmly established, the interesting fact about these structural shifts in economic activity for our propose is not so much the ultimate decline in the importance of agriculture (in relative terms) as the rate at which is occurred. To quote Paul Bairoch, "the proportion of active persons in agriculture

diminished at a rate of less than 0.4 per cent a year till 1860, at about 0.9 per cent from 1860 to 1950, but at 4 per cent from 1950 to 1970. The changes in redistribution of the active population in western developed countries have thus been more important in the last twenty years".

The above historical experience tells us that the sectorial redistribution of the active population is time-taking process. Unlike structural change based on income criterion, structural change based on employment is a slow process. This is demonstrated by the Indian experience also.

Let us look at the trends in occupational structure of active population (work force). The work force engaged in primary sector (agriculture, livestock, forestry, fishing, hunting plantations etc.) decreased from 71.7 per cent in 1901 to 68.8 per cent in 1981. This percentage further declined to 66.75 per cent by 1991. If we take agriculture alone in the primary sector, the decline between 1901 and 1981 was from 66.6 per cent to 66.50. By 1991 this percentage was 64.85. That is, if we go by employment criterion, structural change in the Indian economy has not been significant. The share of secondary sector increased from 12.6 per cent in 1901 to 13.5 per cent in 1981. The percentage was 12.75 by 1991. The share of tertiary sector (trade and commerce, transport, storage and communications and allied services) increased from 15.7 per cent in 1901 to 17.7 per cent in 1981. The percentage was 20.50 by 1991.

Two structural features of the Indian economy emerge clearly from the above account:

1. Agriculture continues to be important in the Indian economy. A little less than 50 per cent of national income originates in the agricultural sector.
2. There is only slight structural change in the economy if we go by the employment criterion. Agriculture still accounted for more than 65 per cent of work force in early 1990s.

The underdeveloped nature of the Indian economy becomes evident when we compare the employment structure of the Indian economy with that of a more developed country like U.S.A. Agriculture in USA in 1986 accounted for only 7 per cent of total work force. The industrial sector and tertiary sectors accounted for 36 per cent and 57 per cent respectively.

In the remaining two sections of this unit we will consider some more structural dimensions of the Indian economy. Structure of and changes in foreign trade sector are separately dealt with in the block dealing with external sector.

Activity - D

1. Explain basic structural changes experienced by the Indian Economy :

2. Explain major reasons for the slow growth of non-agricultural employment in the Indian economy.

8.5 TRENDS AND COMPONENTS IN INDIA'S SAVINGS AND INVESTMENT

Given the supply of labour force and its annual rate of growth, economic growth is primarily a matter of capital accumulation and technological progress (which results in higher resource productivity). Capital accumulation in different sectors of the economy takes place through investments in those sectors. To finance investments, it is necessary to save out of current income. Thus saving rate (saving income ratio) is an important determinant of achievable economic growth rate. Further, a well - developed financial system is necessary for mobilising savings from net surplus units in order to lend to the net deficit units largely to finance their investment activity. Financial intermediation between the net surplus units and the net deficit units is the core function of the financial system. In India both bank and non-bank financial intermediaries play an important part in this respect.

Trends in Saving Rates

In our country, the savings rate (net domestic saving as percentage of NNP at current prices) was a mere 6.2 per cent in 1950-51. In the same year, the household sector accounted for Rs. 441.3 crores of the total net domestic saving of Rs. 572.2 crores or in percentage terms 77.1 per cent of the total net domestic saving. Of the total household saving of Rs. 441.3 crores, about 96 per cent was held in the form of physical assets and about only 4 per cent was held in the form of financial assets. This is one aggregative indicator of economic under-development, on the one hand, and financial under-development on the other, of the country at that time.

But during the last four decades and more years the country has experienced significant economic and financial development. The saving rate has been recording significant improvements. From 6.2 per cent in 1950-51, it rose to 9.3 per cent by 1960-61. By 1980-81 it further rose to 13.5 per cent. By 1996-97 it rose to 18.1 per cent.

Households, private corporate sector (including co-operatives) and public sector are three sources of saving. What has been the trend in respect of the relative contributions to national savings of these sources? In 1960-61, household sector accounted for 74.4 per cent of the total net domestic saving. Next in importance was the private corporate sector (including co-operatives) which accounted for 13.5 per cent of the net domestic saving. By 1989-90 the picture has changed significantly. Household sector accounted for 122.3 per cent of the net domestic saving. The saving rate of the corporate sector fell significantly and was at the level of about 2.9 per cent. Public sector saving turned negative and stood at (-) 25.2 per cent of the net domestic saving. By 1996-97, the latest year for which data were available the aggregate saving rate reached the level of 18.1 per cent. While the saving rate of household sector and private corporate sector were 19.1 per cent and 1.5 per cent respectively, the saving rate of the public sector was (-) 2.5 per cent. Thus the household sector (which includes apart from individuals, all non-government, non-corporate enterprises) accounts for most of the saving in the economy. The dissaving of public sector was increasing from year to year during the last 20 years.

Household saving takes broadly two forms. One is the form of physical assets. Savings in the form of physical assets comprise additions to construction machines and equipment and inventories. Savings in the form of financial assets comprises of currency, deposits with banks and with corporate enterprises, provident / pension funds, claims on government, insurance and compulsory deposits. In 1960-61 financial assets accounted for 33.5 per cent of the gross savings of the household sector. The remaining 66.5 per cent saving were in the form of physical assets. By 1989-90 the saving in the form of financial assets substantially rose and accounted for 51.3 per cent, the remaining 48.7 per cent being accounted for by saving in the form of physical assets. As financial development proceeds, the composition of households saving in the form of

financial assets also changes. By 1996-97 the saving in the form of financial assets rose to 52.89 per cent, the remaining 47.11 per cent being accounted for by saving in the form of physical assets. Thus there took place significant financial development during the last 36 years.

Composition of Household Saving in the Form of Financial Assets

Let us now look at changes in the financial assets structure of the household sector. The significant changes in the composition of assets of the household sector indicate rapid strides made by the financial system of the country. The currency component decreased in relative importance as its share in the total gross saving decreased from 31.8 per cent in 1960-61 to 17.8 per cent in 1987-88. By 1997-98 the currency component accounted for only 6.93 per cent of the total household saving in financial assets, while bank deposits accounted for 45.5 per cent. The phenomenal growth of banking facilities and development of non-bank financial intermediaries and spread of banking habit among households become evident from this. There is still an untapped potential in respect of government securities, investment in Unit Trust of India and life insurance business. Through evolving an appropriate structure of interest rates and through LIC rationalising its premium structure which helps in boosting its business, the potential can be realised.

Investment and Capital Formation

Saving, when invested, results in capital formation. Gross Domestic Capital Formation (GDCF) is classified into two components - A. Gross Fixed Capital Formation (GFCF), B, Changes in the Stocks or Inventories. The share of former improved from about 84.0 per cent in 1950-51 to 92% in 1990-91. It stood at 92.77 per cent by 1995-96. This was healthy trend because it indicates that inventory accumulation was low.

Gross domestic capital formation as percentage of gross domestic product increased from about 18 per cent in 1960-61 to about 23.0 percent in 1990-91. It further increased to about 23.2 per cent by 1996-97. This shows a significant improvement in investment effort. As for the division of GDCF between public sector and private sector, in 1960-61 while GDCF in public sector was 39.9 per cent, that in private sector was 6.11 per cent. By 1990-91 these percentages were 37.5 and 62.5. By 1996-97, public sector share in GDCF declined to 28.74 per cent while that in private sector increased to 71.26 per cent.

The economic growth rate has not been commensurate with the rate of investment. Among many reasons for this (such as under-utilisation of productive capacity, inefficiency of resource use, etc.), rising capital output ratio has been one important factor.

Activity E

1. Define saving rate and identify the most important economic agent which has been responsible for making major part of domestic savings.

2. What are the financial assets household sector holds in its portfolio.

3. Indicate the differences among financial assets from liquidity, risk and return points of view.

8.6 TRENDS IN MONETARY FACTORS AND PRICE LEVEL

A serious concern for the Indian economy since the middle of the Second Plan period has been the upward trend in the general price level. The price trends are related to, among others, the trends in money supply and government budget deficits. The imbalance between demand for and supply of wage goods, particularly food, triggered the price rise in early 1960s and several other factors have made inflation a persistent feature of the Indian economy.

Money supply has increased rapidly and regularly. The money supply with public (currency plus demand deposits, plus other deposit with RBI, referred to as M_1 in RBI publications) during the 21 year period 1970-71 to 1991-92 increased at the annual average rate of 17.7 per cent. In only one year (1977-78) it registered a fall from Rs. 15609 crores to Rs. 14388 crores. In all other years, M_1 registered positive growth rates. One interesting fact is that while the average annual growth rate of M_1 during the 19 year period 1970-71 to 1987-88 was 13.12 per cent, during the subsequent four year period from 1988-89 to 1991-92 it was 18.5 per cent. Thus, prior to the severe economic crisis in 1991, M_1 was growing at a significantly high rate, higher than the average for the period 1970-71 to 1987-88. If we take the recent period 1993-94 to 1997-98, the average growth rate of M_1 was 15.59 per cent.

Money supply growth rate has been an important factor behind the Indian inflation experience. The three principal factors responsible for the expansion of money supply are : (a) Bank credit to commercial sector, (b) Bank credit to government and, (c) Net foreign exchange assets of the banking sector.

Inflation rate based on Wholesale Price Index (WPI) averaged 9 per cent during the period 1970-71 to 1991-92. It reached high levels during the two years 1973-74 (20.2 per cent) and 1974-75 (23.2 per cent).

Inflation rate based on Consumer Price Index (CPI) numbers (urban non-manual employees) averaged about 9 per cent reaching the highest level 22.2 per cent in 1974-75. Besides the government deficits and the consequent money supply growth rate, several structural and institutional factors have been at the root of inflationary rise in prices in India beginning from mid-1950s at a slow rate, accelerating from mid-1960s and recording considerable high rates during the first half of 1970s. The following factors have been responsible for inflation:

1. The very plan strategy (heavy industry strategy) for accelerating development and the consequent trends in the composition of domestic output and foreign trade with adverse consequences for the domestic price level.
2. Closely related to the above is the forced pace of structural change with little regard for sectoral balance and price stability.
3. Role of expectations emanating from inflationary psychology.

4. Plethora of controls inspired by ideological fixation with no firm economic basis and ineffectiveness in operating them leading to the growth of parallel economy making monetary and fiscal measures almost ineffective.
5. Ineffective institutional measures for redistribution of wealth and income.
6. Inflationary nature of the role of distributive trade prompted by the seller's market conditions.
7. Exogenous shocks such as wars and oil price hikes.
8. International transmission of inflationary pressures.

What has been the inflation record during the post-reform period? From a high of 13.7 per cent during 1991-92 the inflation rate based on the WPI came down to 10.1 per cent during the year 1992-93. It fell further to 8.4 per cent during 1993-94. After registering an increase in 1994-95 (10.9 per cent) it declined to 7.7 per cent in 1995-96. It further fell to 6.4% during the year 1996-97. The inflation rate reached the lowest level during the period 1997-98 (4.8%). The average inflation rate for the period 1992-93 to 1997-98 works out to about 8% lower than the average inflation rate during the period 1970-71 to 1991-92 (9 per cent).

8.7 OTHER RELEVANT STRUCTURAL DIMENSIONS

Some of the other structural dimensions of the Indian economy are:

1. As for the tax structure, heavy reliance on indirect taxes and declining importance of direct taxes such as income tax, have been resulting in adverse consequences so far as the objectives such as price stability and reduction in inequalities in income and wealth distribution are concerned.
2. Growth in non-development government expenditure has been a significant factor in several economic ills facing the economy.
3. Heavy reliance on debt financing of government expenditure has been another feature of the Indian fiscal system.
4. Rapid population growth largely because of fast decline in death rate and very slow decline in birth rate is another feature of the country with adverse consequences.
5. The economic reforms initiated since 1991-92 included tax and other fiscal reforms. The government has made several changes in the tax structure with a view to make it more equitable, conducive to growth and simple. The personal income tax rates were reduced, with the highest marginal tax rate brought down to 30 per cent. The corporate tax rates were also reduced. In the field of indirect taxation, the rates of customs duties were brought down to reduce costs and make our exports competitive in the international markets. The ambit of MODVAT was extended while excise duties on several commodities were reduced. The number of rates of excise duties was brought down and many specific duties were converted into ad valorem duties. Tax on services was introduced. All these changes had their impact on the revenues from these taxes. Remember, from the stand point of analysis of business environment it is important for you to gain mastery over the structural dimensions we have examined in this unit.

Activity - F

1. Defining price inflation, explain major causes of inflation.

2. Explain the components of M_1 .

3. Explain the usefulness of consumer price index numbers.

8.8 POPULATION AND OTHER DEMOGRAPHIC TRENDS AND STRUCTURE

The main problem in India is the high level of birth rates accompanying falling death rates. The rate of growth of population which was about 1.3 per cent per annum during 1941-50 rose to 2.1 per cent during the period 1981-91. The chief cause of the rapid growth of population was the steep fall in death rate from 49 per thousand during 1911-20 to about 11 per thousand by the end of 1980's while the birth rate declined from about 49 per thousand during 1911-20 to about 31 per thousand by the end of 1980s.

The fast rate of growth of population, given the rate of growth of GNP, implies lower per capita GNP growth rate. For example, if GNP growth rate is 5 per cent per annum and population growth rate is 2 per cent, then per capita GNP growth rate is 3 per cent per annum. To maintain a rapidly growing population, the requirements of food, clothing, shelter, medical and educational facilities and so on will be rising. Therefore a rapidly rising population imposes greater economic burdens, and consequently, the society has to make greater efforts to accelerate the process of economic growth. Moreover rapidly rising population implies larger additions to labour force and higher dependency ratio. In 1990, for example 36.9 per cent belonged to 0-14 age group, while 58.7 per cent belonged to age group of 15-64 in India's population. The rapid growth of labour force creates a higher supply of labour than demand for it leading to the problem of chronic unemployment.

One heartening feature is that over the last three decades there has been declining trend in population growth rates. During 1965-80, the average annual population growth rate was 2.3 per cent. In subsequent 1980-90 period, it declined to 2%. With the government policies for

population control and family welfare it is expected that by the end of this century population growth rate will come down to 1.7 per cent. But right now heavy population pressure is causing severe hardships, particularly for the low income households.

As for the sex composition of population, the sex ratio (females per 1000 males) declined from 972 in 1901 to 929 in 1991. The explanation for declining sex ratio lies in the poverty of the Indian people. In a country where even after more than 40 years of planned economic development nearly 35 per cent (the poverty estimates differ widely) of the population live below the poverty line, we have high infant mortality rate, extremely poor or non-existent medical facilities, extremely unhygienic conditions of living and absence of prenatal and post-natal care, high death rate among women - are all manifestations of an object low level of living of the people. Preference for male children and attempts to avoid female children is rather a recent phenomenon which contributes to keeping the sex ratio at lower level which is an important demographic dimension. As noted before, rapid population growth implies high dependency ratio 0-14 and 60 and above age groups constitute dependent population. In 1911, 0-14 age group constituted 38.8 per cent of population. In the same year 60 and above age group constitute 1.0 per cent of population. Together they constituted 39.8 per cent. By 1981, the first age group constitute 39.5 per cent of population and the latter age group constituted 6.4 per cent. Thus the percentage of dependent population increased from 39.8 per cent in 1911 to 45.9 per cent in 1981. A high proportion of children (0-14 age group) only reflects a large proportion of unproductive consumers. To reduce the percentage of non-productive consumers, it is essential to bring down birth rate.

Rural urban composition of population is an important demographic dimension, particularly from the point of view of economic development. Along with economic development in general and industrialisation in particular the rural-urban composition of population has been changing in India. In 1901, 89 per cent of Indian population was rural, the remaining 11 per cent being the urban population. By 1991 the percent of population declined to 74.3 per cent, while that of urban population increased to 25.7 per cent.

The quality of population can be judged from life expectancy, the level of literacy and the level of technical training attained by the people of a country. The literacy rate has gone up from 18.2 per cent in 1951 to 52.2 per cent in 1991. Life expectancy at birth has gone up from 41.2 per cent in 1951 to 60.8 per cent in the early 1990s. Education levels also have improved. But in respect of all these, the country is to go a long way for achieving higher standards of living.

Activity - G

1. For India population growth is a problem, why?

2. What is the significance of age-wise-distribution of population.

3. Comment on India's literacy rate, longevity and infant mortality rate.

8.9 SUMMARY

In this unit, we have dealt with several structural dimensions of the Indian economy. We have examined in detail India's growth and development experience. We have adequate account of structural changes that have been taking place in the Indian economy during the post independence period.

8.10 SELF-ASSESSMENT TEST

List and explain several structural dimensions of the Indian economy.

8.11 FURTHER READINGS

1. Government of India Economic Survey, different years, for useful data and information about the Indian economy.
2. Reserve Bank of India Report on Currency and Finance for different years for data and information relating to the Indian economy.
3. Ruddar Dutt and K.P.M. Sundaram, Indian Economy, 1999.
4. V. Lakshmana Rao, Economic Development of India, Allahabad Chugh Publication, 1987, pp 3-101.
5. V. Lakshman Rao, Essays an Indian Economy, New Delhi, Asish Publishing House, 1994, (relevant essays about trends in money supply and price level and Indian development and growth experience).

UNIT-9: **SECTORIAL DIMENSIONS OF INDIAN** **INDUSTRY**

Objectives

After reading this unit, you will be able to :

- Understand India's industrial sector and components of it;
- Obtain an overview of India's industrial growth experience;
- Examine various dimensions of the structure of Indian industry;
- Identify and explain structural changes in the industrial sector; and
- Obtain a picture of the ownership pattern of the industrial sector in India.

Structure

- 9.1 Introduction
- 9.2 An Overview of India's Industrial Growth Experience
- 9.3 Structural Changes in the Indian Industrial Sector
- 9.4 Ownership Pattern of the Industrial Sector
- 9.5 Summary
- 9.6 Self-Assessment Test
- 9.7 Further Readings

9.1 INTRODUCTION

Before the rise of the modern industrial system in the world economy, Indian producers (largely artisan classes) had a world-wide market. Indian muslin and calicos were in great demand world over. Indian industries not only supplied all local needs but also enable India to export its finished products. Indian exports consisted chiefly of manufactures like cotton and silk fabrics, calicos, artistic ware, silk and woollen clothing.

The impact of the British rule and the industrial revolution that took place in Britain led to the decay of the Indian handicrafts. Instead, machine-made goods started coming to India. The gap created by the decay of Indian handicrafts was not filled by the rise of modern industry in India because of the British policy of encouraging the imports of manufactured products into and export of raw materials from India.

The British Government in India provided discriminatory protection to some selected industries since 1923. This protection was accompanied by the "most favoured nation" clause for British goods. Despite this factor, because of the "Pioneering zeal" and "fostering care" (Prof. Lokanathan's Phrases) of the early Indian entrepreneurs, some industries such as cotton textiles, sugar, paper, matches and to some extent, iron and steel did develop in the country. But capital goods industries were not fostered during the British period. The industrial pattern of India on the eve of planning (1951) was marked by low capital intensity, predominance of small enterprises, limited development of factory sector and imbalance between consumer goods and capital goods industries. This lop-sided pattern of industry with the predominance of consumer goods industries had to be corrected through planning in the post-independence period.

9.2 AN OVERVIEW OF INDIA'S INDUSTRIAL GROWTH EXPERIENCE

The progress of industrialisation process during the four decades and more since the beginning of the planning era (1951 - 56 was the first plan period and presently the Tenth plan in progress) has been a significant feature of the Indian economic growth and development experience. The process of industrialisation initiated as conscious and deliberate policy under Industrial Policy Resolutions of 1948 and 1956 involved heavy investments in basic and heavy industries besides those in consumer goods industries. As a result of efforts for rapid industrialisation, a firm industrial base has been created. Industrial production grew by about 5 times and India now is the tenth most industrial country in the world. India now has a well diversified industrial sector covering the entire range of consumer, intermediate and capital goods industries. The progress the country has made in respect of industrial sector is clearly reflected in the commodity composition of India's foreign trade. The share of imports of manufactured goods in foreign trade has steadily declined, while industrial products, particularly engineering goods have become a growing component of India's exports. Further the rapid progress in industrialisation has been accompanied by a corresponding growth in technological and managerial know-how for efficient operation of the most modern and sophisticated industries and also for planning, designing and construction of such industries.

The diversification of India's industrial capability also is evident. India could achieve self-sufficiency in consumer goods. Growth of basic and capital goods industries has been particularly impressive. India can now sustain the future growth of key sectors of the economy primarily through domestic production, with only marginal imports. Further, the infrastructure including research and development capability, consultancy and design engineering services, project organisation services and innovative capability to improve and adapt technologies to suit the domestic factor endowment have shown an impressive record of progress. Now we turn to industrial growth rates.

During the third plan period, but for the concluding year of the plan period, the annual growth exceeded 8 per cent (see Table 9-1). During the subsequent three annual plans the growth rates fell significantly, except during 1968-69 when growth rate was 6.7 per cent. The period was marked by low growth rates, the average growth for the period being 2.83%.

The industrial growth recovered significantly during the fourth plan period but the average growth rate during the period (4.4 per cent) was significantly lower than that during the third plan period (8.2%). The industrial growth performance during the V plan was a significant improvement over the preceding years after the third plan period. The average growth rate recorded during the fifth plan period was 6.24 per cent. During the period the highest growth rate was recorded during the year 1976-77 (9.5 per cent). Subsequent to the fifth plan, the growth rate recorded during the annual plan 1979-80 was negative (-1.6 per cent). During the sixth plan period the industrial sector not only recovered but registered an annual growth rate of 5.92%. During the subsequent seventh plan (1985-90) the industrial growth proceeded at a substantial rate and the average annual growth rate during the period was 8.5 per cent, the highest growth rate achieved since the end of the third plan. During the two annual plans 1990-91 and 1991-92, the growth rates were respectively 8.3 per cent and 0.6 per cent. It is to be remembered here that 1991-92 was a severe crisis year, the crisis inducing the initiation of New Economic Policy package by P.V. Narasimha Rao Government. Thanks to the economic liberalisation policy, industrial growth recovered during 1992-93 (2.3 per cent) and registered further increase during 1993-94 (6.0%). During the subsequent year (1994-95) growth rate further increased to 8.4 per cent. The growth rate recorded during subsequent year 1995-96 was the highest during the planning era (12.82 per cent). The subsequent two years were marked by economic and industrial recession. The

growth rate fell to 5.56% during 1996-97. It registered a slight increase during 1997-98 (6.58 per cent). On the whole the industrial performance during the eighth plan was satisfactory.

During the 1990s, the Indian industrial sector has been through periods of robust growth and severe slow-down. The variations in performance took place with a backdrop of substantial policy changes during the same period. While the policy changes were in most cases across the board, in several cases, the policies impacted specific industries. As a result, the industrial performance of the 1990s provides a fertile ground to investigate the performance of the various industries during the period. Here, we can distinguish three phases :

1. First, the period immediately preceding the initiation of reforms - 1989-90 to 1992-93. This includes the "Crisis" period of 1990-91.
2. 1993-94 to 1995-96. This was the period of rapid growth.
3. 1996-97 to 1997-98. This was the period of the slowdown.

The industrial production has three components in it, mining, manufacturing, and electricity. The index of production in mining increased from 45.5 in 1960 (base year 1980-81= 100) to 245.8 in 1994-95, an increase by about 6.4 times (Table 9.2). With the base 1993-94=100 the mining index increased from 107.6 in 1994-95 to 122.4 in 1997-98 (Provisional). The index of manufacturing during the period 1960 to 1994-95 increased from 38.2 to 243.6, an increase by about 6.4 times. With 1993-94 as base year, the index of manufacturing production increased from 108.5 in 1994-95 to 140.5 in 1997-98 an increase of about 1.3 times. The index of electricity generation increased from 14.6 in 1960 to 314.6 in 1994-95, an increase by about 21.5 times. As for the recent period the index of electricity generation increased from 108.5 (base 1993-94) to 130.0 in 1997-98. Thus the industrial growth during the recent period did receive a set back as a result of industrial recession.

Now let us look at the manufacturing sector growth record. Manufacturing is major segment of the industrial sector. The weight of manufacturing in the general index of industrial production is 77.11 (the weights for mining and electricity were 11.46 and 11.43 respectively). As for the growth of the manufacturing sector, we look at the overall manufacturing sector as well as its components, factory and non-factory segments. We measure manufacturing growth rate by growth in gross value added by manufacturing. During the period 1960-61 to 1970-71 the manufacturing sector as a whole recorded growth rate of (growth of gross value added at constant (1980-81) prices) 5.2 per cent, while factory and non-factory sectors recorded 6.4 per cent and 3.8 percent growth rates respectively. During the subsequent 1970-71 to 1980-81 period, growth rates fell. The growth rates recorded by manufacturing sector as a whole was 4.0 per cent, the growth rates recorded by the factory and non-factory sectors being 3.7 per cent and 4.4 per cent respectively. During the subsequent 1980-81 to 1990-91 period, the manufacturing sector as a whole recorded a growth rate of 6.0 per cent. During the period the factory sector recorded a higher growth rate (8.5 per cent) than non-factory sector (6.3 per cent). The 1990-91 to 1993-94 period was marked by very low growth rates. The growth rate of the manufacturing as a whole was 1.1 per cent while that of the factory and non-factory segment were 1.2 per cent and 1.0 per cent respectively.

The share of the factory sector in gross value added in manufacturing sector increased from 52.0% in 1960-61 to 62% in 1993-94, while that of the non-factory sector declined from 48.0% to 37.9%. Thus over the period 1960-61 to 1993-94, factory sector recorded higher growth than the non-factory sector (Gross value added in manufacturing is the value of output of manufacturing sector minus the value of intermediate inputs. Gross value added is gross of depreciation).

Industrial concentration in a few regions continues to be significant feature of the industrial economy of India. If we look at the state-wise distribution of net value added in manufacturing

sector during 1992-93, regional inequalities in respect of industrial development become very clear. In 1992-93, in manufacturing net value added, Maharashtra topped the list net value added of Rs. 14019 crores followed by Gujarat (Rs. 7029 crores) Tamil Nadu (Rs. 6600 crores), and Uttar Pradesh (Rs. 4961 crores). These four states together accounted for about 55% of the net value added in manufacturing sector in India during the year 1992-93.

Activity - A

1. Explain the components of the industrial sector.

2. Shifting the base to 1992-93, calculate the average industrial growth rate during the 8th plan period.

3. Making use of data in Table-9.2, compare average annual growth rates in respect of mining, manufacturing and electricity.

9.3 STRUCTURAL CHANGES IN THE INDIAN INDUSTRIAL SECTOR

In this section we will examine several dimensions of the structure of Indian industry and changes in these structural dimensions. As industrial development proceeds in an economy, several structural changes take place in the industrial sector. Historically, industrial development has proceeded in three stages. In the first stage, industry was concerned with the processing of primary products, milling grain, extracting oil, tanning leather, spinning vegetable fibres, preparing timber and smelting ores. The second stage in the evolution of secondary industry comprises the transformation of materials making bread and confectionery, foot wear, metal goods, cloth, furniture and paper. The third stage consists of the manufacture of machines and other capital equipment to be used not for the direct satisfaction of any immediate want but in order to facilitate the processes of production. W.G. Hoffman (The Growth of Industrial Economies, Oxford, 1958) gives operational criteria of the degree of industrial development. He classified various stages in terms of the ratio of consumer goods output to that of capital goods output. In the first stage the consumer goods industries are of overwhelming importance, their net output

being on the average five times as large as that of capital goods industries. The ratio is 2.5 : 1 in the second stage and falls to 1 : 1 in the third stage and still lower in the fourth stage. This classification emphasises the increasing role of the capital and producer goods industries in the economy as industrial development progress over a period of time.

In the post-independence period economic planning for overall development succeeded in laying firm foundations for future economic development. The heavy industry strategy formulated and implemented from the beginning of the Second Five Year Plan helped in creating a strong industrial base. Capacities in substantial quantities have been created in basic, key and heavy industries.

It is possible for us to infer changes in the composition of the output by looking at (1) weights assigned to major industry groups in index of industrial production, (2) percentage changes in the indices of industrial production based on use based classification of industries and (3) annual compound growth rates of industrial production in respect of different categories of production. The change in weights given to different categories of output (output of basic goods, capital goods etc.) indicate the changing structure of industrial output. The weight given to basic and capital goods industries in 1956 was about 28 per cent. By 1993-94 this weight increased to 45 percent. On the other hand weight attached to consumer goods industries declined from 48% in 1956 to about 28% in 1993-94. Thus during the period the relative importance of basic and capital goods industries increased and that of consumer goods industries decreased signifying structural change in the industrial sector. Indian experience supports the thesis of Haffman that as industrialisation proceeds composition of industrial output changes and the relative importance of basic and capital goods industries increases, while that of consumer goods industries decreases.

The structural change in the industrial sector can also be gauged from the relative growth rates of different categories of industries. If we take the compound growth of indices of industrial production, we find differences in respect of growth rates of different categories of output signifying changes in the structure of industrial output. Industrial output is classified into (i) output of basic industries such as finished steel (ii) output of capital goods industries such as machinery (iii) output of consumer goods industries such as sugar and (iv) output of intermediate goods industries. During the period 1980-81 to 1990-91, while the compound growth rate of output of basic and capital goods industries was about 19%, that of consumer goods industries was only about 7%. Within the consumer goods industry the output of consumer durables grew at substantially higher rate (14%) than consumer non-durables (5%).

Activity - B

1. Refer to RBI, Report on Currency and Finance and give the composition of each of the following categories of industries 1. Basic goods, 2. Capital goods, 3. Consumer goods.

2. Explain the meaning of intermediate goods.

Table-9.3 gives the changing pattern of weights given to different categories of industries. The change in weight given to an industry group signifies the change in relative importance of that group.

As noted before changes in weights assigned to different categories of industries signify changes in relative importance of these categories in total industrial output.

Table 9.3 : Base Years

Industry Group	1956	1960	1970	1980-81	1993-94
1	2	3	4	5	6
Basic Industries*	23.33	25.11	32.28	39.41	35.51
Capital Goods Industries*	4.71	11.76	15.25	16.43	9.69
Intermediate Goods*	24.59	25.88	20.95	20.51	26.44
Consumer Goods Industries*	48.37	37.25	31.52	23.65	28.36
Total Weight	100.00	100.00	100.00	100.00	100.00

* See RBI, Report on Currency and Finance for details about the composition of each category.
Source : RBI, Report on Currency and Finance, different years.

Activity-C

1. What was the percentage of consumer goods output in 1956.

2. What is the percentage of consumer goods industries in total industrial output in 1980-81.

3. What is the trend in the share of intermediate goods in total industrial output during the period 1956-81.

Size of Producing Units - Another Structural Dimension

The size of an industrial unit can be measured using different criteria. Output, total assets, fixed capital and employment are some of the major criteria to measure size of the industrial units. Changes in the average size of the industrial units represent an important structural change of the industrial sector in an economy. We turn to this structural dimension in this section.

As future managers you must know about this important dimension of the structure of industry. We may list the circumstances under which a large firm or a small one would be more efficient. Such analyses provide guidance for making the proper choice of the optimum size for the firm. A large firm would be more efficient in situations where :

- a) The product is standardized and can be produced on mass scale with longer production runs such as iron and steel, sugar, industrial chemicals and fertilizers.
- b) The product and/or machines used in its production are large in size such as automobiles, ships and electricity generation.
- c) The economics of linked processes are significant as in the case of pulp and paper industry and steel among others.
- d) The market for the product are concentrated and/or transport cost are considerable low in comparison to the price of the product.
- e) There are occasional indivisibilities in different units or operations of the plant which are to be balanced and
- f) Research activities are essential to compete in the market such as in chemical industries

In the similar way a small firm would be more efficient in situations where :

- a) The product is to be made to an individual specification or where varieties or product differentiation are required in the market for existence i.e. standardization and mass production are not economical. Examples are ornaments and fabrics;
- b) The raw materials and markets for the products are geographically dispersed and transport costs are quite significant e.g. bread and brick making;
- c) The demand conditions change frequently as a result of which quick adjustments are needed to adapt to such changes e.g. garment making;
- d) The nature of work done changes frequently due to technical condition e.g. agriculture and allied industries; and
- e) The suppliers of the raw materials are a few and potential market for the product is small.

Complete separation of situations for large scale and small scale units is not possible. There are many industries where small scale and large scale production is carried on side by side. Examples are engineering industries, cloth making, shoe making and several consumer products. In fact, if we go through the industrial structure of a country, we will find such situations in most of the industries. Small units in an industry exist along with larger ones mainly because (i) they may be relatively new and it is normal to grow large from small beginnings in due course of time (ii) they may be supplying finished products to the larger units under some type of sub-contracting; and (iii) they may be producing a highly specific variety of products in a differentiated product industry. All such small units may be equally efficient as the bigger units.

With this background about the size of industrial units, let us examine the size dimension of the Indian industry. If we look at the size of units in the factory sector, using employment as

the criterion of the size, in 1973-74, 0 to 49 employees size class (lowest size) accounted for 77 per cent of the factories, but only for 8.7 per cent of value added by the factory sector (see Table-9.4). In the same year the large-sized units (employing more than 1000 employees) accounted for only 1.4 per cent of the number of factories, but accounted for 51.2 per cent of net value added in the factory sector. By 1992-93 the least sized units (0 to 49 employees) accounted for 76.1 per cent of the number of factories and 8.2 per cent of net value added in the factor sector. In 1992-93 the relatively larger units (employing more than 1000 employees) account for 0.8 per cent of the number of factories and for 43.8 per cent of the total net value added in the factory sector. If we look at the size-wise distribution of the factory sector industrial units, using employment as size criterion, we find gradual increase in the size of industrial units. Thus as industrial development proceeded, the average size of industrial units has increased. So, structural change in Indian industrial sector is observable in respect of one dimension of structure of the sector, namely size of industrial units measured by employment. Similar trend is observable in respect of size measured by capital (gross value of plant and machinery). (See Table-9.5)

Activity - D

1. List some criteria by which the size of industrial unit could be measured.

2. Refer to Table-9.4. Reorganise the size distribution with 0-199, 200-999 and 1000 and above, as size classes and find out the shares of these classes in employment, output and value added.

3. Refer to Table-9.5. Reorganise the size distribution with 0-50, 50-1000 and 1000 and above, as size classes and find out the shares of these classes in employment, fixed capital and value added.

9.4 OWNERSHIP PATTERN OF THE INDUSTRIAL SECTOR

After independence India wanted to adopt planning for economic development. We have gone through nine Five Year Plans. We are now going through the Tenth plan period (you have learnt about Indian economic planning in Unit 7 earlier). We opted for a mixed economy with both private and public sectors, complementing each other rather than competing. The scope of each sector was well defined in the industrial policies announced from time to time by the Government. Industrial Policy Resolution of 1956 was the major policy announcement before the announcement of the New Industrial Policy in 1991. The hallmark of this new policy is economic liberalization. We will learn about these policies in detail in later Units 12 and 13. Here our interest is to describe the structure of the Indian industrial sector on the basis of ownership pattern.

Table-9.6 gives structure of ownership of industrial factory sector in 1992-93, the latest year for which data are available from the publication of the Centre for Monitoring Indian Economy (CMIE, **India's Industrial Sector**). The public sector accounted for 6.1 per cent of total number of factories, 28% of employees, 55 per cent of net fixed capital and 32.1 per cent of net value added by the industrial factory sector. Public sector includes enterprises of the Central Government, State and Local Governments.

The private sector including cooperative sector accounted for 92.3 per cent of total number of factories, 69.1% of workers, 67.2% of employees, 39.4 per cent of net fixed capital and 61.5 per cent of value added. This sector has four components (i) corporate enterprises (ii) partnerships (iii) individual proprietorship and (iv) cooperative enterprises.

Joint sector (enterprises owned jointly by private and public or government interest) accounted for 1.5 per cent of total factories, 4.4 per cent of workers, 4.7 per cent of employees, 5.6 per cent of net fixed capital and 6.4 per cent of value added.

Regional inequalities in the distribution of industrial activity and significant industrial concentration are two more dimensions of the structure of India's industrial sector. Table-9.7 gives the relevant inter-state data.

Activity - E

Refer to Table-9.6 and attempt the following.

1. List a few observations about the structure of public sector.

2. Comment on the size of (i) cooperative sector and (ii) joint sector.

3. Explain the organizational forms in the private sector.

Activity - F

1. Go through Table-9.7 given at end of the unit and write a note on inter-state disparities in manufacturing sector development.

We explained the pattern of ownership of industrial factory sector above. Now you will learn more about the public sector and private sector.

Public Sector

In India's mixed economy, public sector occupies a pivotal position. Public enterprises are expected to make significant contribution to 1. growth in national income, 2. creation of employment opportunities, 3. reduction in income disparities among regions and groups, 4. earning of foreign exchange and 5. generation of surpluses for financing development efforts. Over a period of time, in the post-independence period, the size of the public sector has grown rapidly, and the number of public enterprises as well as the areas of their operation have recorded significant progress. Public sector was expected to achieve "Commanding Heights" in the economy and it did so over a period of forty years. However, the quantitative growth of the public sector was not matched by qualitative performance. Many public sector enterprises were incurring losses. The performance of public sector in general was so discouraging that as part of New Economic Policy announced by the Indian Government in 1991 the scope and role of the public sector was sought to be reduced drastically. An understanding and analysis of economic environment of business in India is not complete without an understanding and objective assessment of our public enterprises. Any activity owned, controlled and managed by the government (central, state and local) comes under public sector. After the attainment of independence and the advent of planning, there has been a rapid expansion of the scope of the public sector. The passage of Industrial Policy Resolution of 1956 and the adoption of the socialist pattern of society as our national goal further led to deliberate enlargement of the role of public sector.

The objectives of the public sector can be briefly stated as follows :

1. to accelerate economic growth and industrialisation of the country by creating the necessary infrastructure for development;
2. to promote fair distribution of income and wealth, inter-personal as well as inter-regional;
3. to promote balanced regional development;
4. to promote the growth of strategic defence oriented industries;
5. to assist the development of small and ancillary industries;
6. to create employment opportunities;

7. to achieve socialist pattern of society;
8. to avoid and circumvent the limitations and abuses of the private sector; and
9. to generate forces of economic and technological self-reliance.

Broadly speaking, the capital - intensity (capital per unit of output) of production in public sector is significantly higher than that of private sector. This is largely due to the differences in nature of investments in the two sectors. The important differences are listed below :

1. A good part of the investment in the public sector goes into economic overhead such as roads, buildings and communications which are essential for economic development but do not contribute to output in the normal sense of the term.
2. The public sector has played a significant role in developing the key industries of the economy and these industries such as iron and steel and power by their very nature are areas of high capital intensity.
3. Many projects in the public sector have longer gestation periods. Capital outlays are large and take time to yield results.
4. Areas of higher output capital ratios fall mainly in the private sector. Examples are consumer goods industries, small-scale and cottage enterprises.

Despite many criticisms against the public sector enterprises, there is no denying the fact that rapid industrialisation of the Indian economy in the post-independence period was mainly due to the growth of the public sector. Strong and well - diversified industrial base has been laid and in many respects India has achieved self-reliance.

Public sector which was expected to achieve "Commanding Height" of the economy did grow very rapidly during the planning era. But inefficiencies of various kinds have become the hallmark of the public sector. Debt financing of public investment became quite common during 1980s decade. Public enterprises have shown very low rate of return on the huge capital invested. This has reduced their ability to regenerate themselves in terms of new investments and technology development. The result is that many of the public enterprises have become a burden rather than being an asset to the government. In the national economic scenario resulting from the economic reforms of 1991, the scope of public sector is reduced and is confined only to infrastructure and strategic industries. The priority areas for growth of public enterprises in future will be the following :

1. Essential infrastructure goods and services.
2. Exploration and Exploitation of oil and mineral resources.
3. Technology development and building of manufacturing capability in areas which are crucial in the longrun development of the economy where private sector investment is inadequate.
4. Manufacture of products where strategic considerations predominate, for example defence equipment. The disinvestment in the public sector units has been taking place as part of economic reforms.

Performance of Public Enterprises

Working of private enterprises is largely governed by the profit motive. All managerial decisions in the working of private enterprises, thus are geared to earn as much profit as possible. These decisions are, of course, constrained by the environment within which an enterprise is to operate. The behaviour of an enterprise working in a competitive environment differs from that operating in (say) oligopolistic environment. But the prime motive in the case of the private enterprise is maximization of profits.

In the case of public enterprises social good is the main goal and working of public enterprises is governed by this goal. Higher utilization of capacity (to produce as much output as possible given the capacity constraint), efficiency in running the enterprise, being accountable to public and following proper pricing policies are some of the norms public enterprises need to satisfy in their working.

For the reasons mentioned earlier the performance of public enterprises cannot be judged solely on the basis of profit criteria. Some of the public enterprises were running on profit while many others were running on losses. The over-all picture reveals that between 1960-61 and 1977-78 percentage of profit after tax to total paid-up capital and reserves has ranged between 0.2 to 4.6 per cent. Thus by the criterion of "profit after tax" the performance of the public sector has been poor.

Table - 9.8 throws light on the financial performance of central public enterprises. As noted before, it is not appropriate to treat profit as the sole criterion of efficiency of the public sector. The gains to employees and welfare expenditures on employees in public enterprises are to be noted in this connection. The real emoluments per employee in the public sector went up from Rs. 11210 in 1978-79 to Rs. 17339 in 1991-92. By 1996-97 per capita emoluments of public sector employees stood at Rs. 113003.

By employment criterion also the performance of the public sector is praise-worthy. Public sector employment increased from 154.84 lakhs persons in 1981 (as on 31st March) to 195.59 lakh persons in 1997. During the same period the employment in private sector increased from 73.95 lakhs persons to 86.86 lakh persons.

The public sector by assuming responsibility of rehabilitation of sick units (Examples, textile mills in private sector) had to bear a considerable burden in order to save 1.5 lakh employees from the spectre of unemployment. This social responsibility explains to some extent the lower profitability of public sector.

By the criterion of capacity utilization also, the public sector performance is found to be better (relative to the private sector) by some studies. The foreign exchange earnings of public enterprises also constitute a performance indicator. For instance the value of exports of central public sector enterprises increased from Rs. 502 crores in 1972-73 to Rs. 6366 crores in 1989-90.

Private Sector

In a mixed economy both private sector and public sector coexist. The respective spheres of private and public sectors are well defined and the two sectors function in a manner that is conducive to the achievement of overall development of the national economy. The private sector is subject to various regulations and laws so that it subserves the social and economic objectives of economic planning for development. The unregulated capitalism in the Western Countries during the 19th century and the first quarter of the twentieth century was found to be suffering from several limitations and evils. The Keynesian Revolution clearly brought out the role of government in ensuring stability in a capitalist economy. The 19th century Police State (in the sense that its main function was limited to maintenance of law and order) has given way to 20th century Welfare State wherein the state plays an important regulatory and promotioned role in the economic realm. The Keynesian revolution has put the last nail into the coffin of virgin-pure capitalism. The regulated or controlled capitalism is an observable fact now.

The private sector refers to all types of individual and corporate enterprises, domestic and foreign, in any field of productive activity with the intention of making a profit. The characteristic of the private sector enterprises is that their ownership and management lies in private hands. The "enlightened self-interest" guides the running of private enterprises. Enterprise, initiative and strong profit motive are the most distinguishing features of private enterprise. 148

Private enterprise with the above characteristics is an integral part of the capitalist economic system in general and a mixed economy in particular.

Agriculture and allied activities which accounted for nearly 40% of the domestic GNP and nearly 65% of employment in early 1990s are completely in the private sector. Small scale and cottage industries, trading, consumer goods industries, construction etc., are some of the other areas in which the private sector has been playing a major part. As noted before, the public sector in contrast to the private sector predominates in basic, heavy and infrastructure industries. One important structural dimension of the private sector is the predominance of the informal or unorganised sector within the private sector.

J.S. Papola ["Informal Sector, Concept and Policy"; The Giri Institute of Development Studies, Lucknow, December 1979 (mimeo)] listed some prominent characteristics of the informal sector units after explaining how difficult it is to precisely define informal sector. Small size of operations, informal structure and family ownership, use of non-modern technology, lack of access to government favours (subsidies etc.), competitive and unprotected product and labour markets are the prominent characteristics of the informal sector identified and elaborated by Papola.

A study of the informal sector in India has come up with the following conclusions:

- Informal sector both in terms of employment and income has been a predominant sector of the Indian economy. In 1981 the sector accounted for 91.1% total national employment and 65.55% of income generated in the economy. During the period 1960-61 to 1981-82, while the organised sector grew at an average annual rate of 12.57 per cent, the unorganised sector recorded a growth rate of 9.37 per cent. The economy as a whole recorded a higher growth rate of 11.36 per cent indicating slight declining trend of the unorganised sector.
- While in the aggregate the above trend is clear, the urban informal sector has been growing during the period. The share of the urban informal sector in the total income of the unorganised sector increased from 29.35% to 43.56% during the period 1960-61 to 1981-82.
- While the share of wage/salary income in the case of organised sector was more than two thirds, in the case of the unorganised sector it was less than a quarter.

From the above, it is clear that within the private sector the unorganised sector was predominant both by income and employment criteria.

Table-9.9 gives growth of the corporate sector.

TABLE - 9.9
Growth of the Corporate Sector in India

	March 1957	March 1996
No. of Companies	29,357	4,09,148
a) Government	74	1,210
b) Non-Government	29,283	4,07,938
Paid-up capital (Rs. Crores)		
All Companies	1078 (100.0)	1,48,046 (100.0)
Government Companies	73 (6.8)	72,878 (48.7)
Non - Government Companies	1005 (93.2)	75,878 (51.3)

Note : Figures in brackets are percentages of total paid-up capital

Source : Ruddar Dutt and Sundaram, Indian Economy.

9.5 SUMMARY

In this unit we acquainted you with several dimensions of India's industrial sector. You have learnt about India's industrial growth experience. We examined several dimensions of the structure of the Indian industrial sector: composition of output and changes in it, size of industrial units and ownership pattern of the industrial sector.

9.6 SELF-ASSESSMENT TEST

1. List and explain the major structural characteristics of India's industrial sector.
2. As industrialisation proceeds in a country, the relative importance of consumer goods industries declines and that of capital goods industries increases. Justify this proposition by using relevant industrial data.
3. Comment on the structure of private sector.
4. Comment on the performance of the public sector.
5. Explain the characteristics of the informal sector.

9.7 FURTHER READINGS

1. Ruddar Dutt and Sundaram, Indian Economy, Latest edition
2. V. Lakshmana Rao, Essays on Indian Economy, Essay No 3, New Delhi, Ashish Publishing House 1994.
3. Centre for Monitoring Indian Economy, India's Industrial Sector, January, 1996.

4. Government of India, Economic Survey, different years.

5. Government of India, Handbook of Industrial Policy and Statistics, 1996.

Table 9.1

INDUSTRIAL GROWTH RATE DURING VARIOUS PLAN PERIODS

	Year	Index	Growth Rate	Average Annual Growth Rate During Plan Period
1	2	3	4	5
		(Base : 1970 = 100)		
Third Plan	1960-61	55.8	--	--
	1961-62	60.4	8.2	--
	1962-63	66.1	9.5	--
	1963-64	72.3	9.3	8.22
	1964-65	78.6	8.8	--
	1965-66	82.8	5.3	--
Annual Plan	1966-67	83.3	0.6	--
	1967-68	84.3	1.2	2.83
	1968-69	89.9	6.7	--
Fourth Plan	1969-70	96.8	7.6	--
	1970-71	100.7	4.1	--
	1971-72	106.4	5.6	4.40
	1972-73	110.6	3.9	--
	1973-74	111.5	0.8	--
Fifth Plan	1974-75	115.1	3.2	--
	1975-76	122.8	6.7	--
	1976-77	134.4	9.5	6.24
	1977-78	140.0	4.2	--
	1978-79	150.7	7.6	--
Annual Plan	1979-80	148.2	(-)1.6	--
Sixth Plan	1980-81	154.1	4.0	--
	1981-82	167.3	8.6	--
	1982-83	174.3	4.1	5.92
	1983-84	184.9	6.1	--
	1984-85	197.4	6.8	--

	Year	Index	Growth Rate	Average Annual Growth Rate During Plan Period
1	2	3	4	5
		(Base : 1980-81 = 100)		
Seventh Plan	1985-86	142.1	8.7	--
	1986-87	155.1	9.1	--
	1987-88	166.4	7.3	8.5
	1988-89	180.9	8.7	--
	1989-90	196.4	8.6	--
Annual Plan	1990-91	212.6	8.3	4.15
	1991-92	213.9	0.6	--
	1992-93	218.9	2.3	--
	1993-94	232.0	6.0	--
		(Base : 1993-94 = 100)		
	1994-95	108.4	8.4	8.34
	1995-96	122.3	12.82	--
	1996-97	129.1	5.56	--
	1997-98	137.6	6.58	--

Table 9.2

INDEX OF INDUSTRIAL PRODUCTION 1960 TO 1997-98

Weight	Index 1980-81 = 100				% Change over the Previous Year			
	Mining	Manu- facturing	Electricity	General	Mining	Manu- facturing	Electricity	General
	(11.46%)	(77.11%)	(11.43%)	(100.00)				
1	2	3	4	5	6	7	8	9
1960	45.5	38.2	14.6	36.0	--	--	--	--
1961	47.9	41.6	16.9	39.3	5.3	8.9	15.8	9.2
1962	52.4	45.6	19.0	43.1	9.4	9.6	12.4	9.7
1963	56.0	49.3	22.0	46.6	6.9	8.1	15.8	8.1
1964	54.3	53.9	25.3	50.6	-3.0	9.3	15.0	8.6
1965	59.9	58.7	27.8	55.3	10.3	8.9	9.9	9.3
1966	61.9	57.9	30.3	55.1	3.3	-1.4	9.0	-0.4
1967	61.8	56.6	33.6	54.4	-0.2	-2.2	10.9	-1.3
1968	65.6	59.6	38.8	57.9	6.1	5.3	15.5	6.4
1969	67.1	63.8	43.9	62.0	2.3	7.0	13.1	7.1
1970	67.8	66.7	48.6	65.0	1.0	4.5	10.7	4.8

Weight	Index 1980-81 = 100				% Change over the Previous Year			
	Mining	Manu- facturing	Electricity	General	Mining	Manu- facturing	Electricity	General
	(11.46%)	(77.11%)	(11.43%)	(100.00)				
1	2	3	4	5	6	7	8	9
1971	68.5	69.7	52.1	67.9	1.0	4.5	7.2	4.5
1972	71.2	73.4	56.8	71.9	3.9	5.3	9.0	5.9
1973	72.5	74.2	55.8	72.2	1.8	1.1	-1.8	0.4
1974	76.7	74.6	60.4	73.5	5.8	0.5	8.2	1.8
1975	86.7	77.4	67.4	77.5	13.0	3.8	11.6	5.4
1976	92.7	86.9	78.0	86.9	6.9	12.3	15.7	12.1
1977	94.8	90.1	80.5	89.9	2.3	3.7	3.2	3.5
1978	96.3	96.3	89.3	96.1	1.6	6.9	10.9	6.9
1979	100.7	96.5	93.9	97.2	4.6	0.2	5.2	1.1
1980	97.7	97.5	96.0	98.0	-3.0	1.0	2.2	0.8
1980-81	100.0	100.0	100.0	100.0				
1981-82	117.7	107.9	110.2	109.3	17.7	7.9	10.2	9.3
1982-83	132.3	109.4	116.5	112.8	12.4	1.4	5.7	3.2
1983-84	147.8	115.6	125.4	120.4	11.7	5.7	7.6	6.7
1984-85	160.9	124.8	140.4	130.7	8.9	8.0	12.0	8.6
1985-86	167.5	136.9	152.4	142.1	4.1	9.7	8.5	8.7
1986-87	177.9	149.7	168.1	155.1	6.2	9.3	10.3	9.1
1987-88	184.6	161.5	181.0	166.4	3.8	7.9	7.7	7.3
1988-89	199.1	175.6	198.2	180.9	7.9	8.7	9.5	8.7
1989-90	211.6	190.7	219.7	196.4	6.3	8.6	10.8	8.0
1990-91	221.2	207.8	236.8	212.6	4.5	9.0	7.8	8.2
1991-92	221.5	206.2	257.0	213.9	0.1	-0.8	8.5	0.6
1992-93	223.7	210.7	269.9	218.9	1.0	2.2	5.0	2.3
1993-94	231.5	223.5	290.0	232.0	3.5	6.1	7.4	6.0
(Base: 1993-94 = 180)								
1994-95	107.6	108.5	108.5	108.4	-	-	-	-
1995-96	117.9	123.5	117.3	122.3	4.6	13.8	8.1	12.8
1996-97	115.6	131.8	122.0	129.1	(-)1.9	6.7	4.0	5.6
1997-98*	122.4	140.5	130.0	137.6	5.9	6.6	6.6	6.6

* Provisional

TABLE-9.4

Structure of Industrial Factory Sector : By Size of Employment

Employment Range (Number)	Factories (Number)	Employees (Number)	Gross Net Value		% Share				
			Output (Rs.Crore)	Added (Rs.Crore)	Factories	Emple- yees	Gross Output	Net Value Added	
0-49	1973-74	49,355	8,37,340	2,913	402	77.0	14.4	14.9	8.7
	1979-80	74,956	1,187,660	7,485	962	78.8	15.5	14.3	8.9
	1984-85	76,072	1,164,763	13,417	1,752	78.5	14.8	12.7	8.4
	1989-90	82,646	1,426,238	31,905	3,867	76.5	17.5	13.8	8.9
	1992-93	90,954	1,509,635	49,463	5,813	76.1	17.3	13.4	8.2
50-99	1973-74	6,911	477,469	1,563	229	10.8	8.2	8.0	4.9
	1979-80	9,800	678,207	4,001	587	10.3	8.8	7.7	5.4
	1984-85	10,480	726,578	7,481	1,113	10.8	9.2	7.1	5.3
	1989-90	13,221	921,688	18,734	2,626	12.2	11.3	8.1	6.1
	1992-93	14,625	1,002,616	30,985	4,298	12.2	11.5	8.4	6.0
100-199	1973-74	3,595	547,328	1,728	341	5.6	9.4	8.8	7.4
	1979-80	4,997	691,118	4,487	761	5.3	9.0	8.6	7.0
	1984-85	4,939	686,911	8,099	1,430	5.1	8.7	7.7	6.8
	1989-90	6,192	851,577	22,224	3,586	5.7	10.5	9.6	8.3
	1992-93	7,172	995,269	39,113	6,574	6.0	11.4	10.6	9.2
200-499	1973-74	2,388	762,680	2,863	621	3.7	13.1	14.6	13.4
	1979-80	2,989	905,452	7,815	1,378	3.1	11.8	15.0	12.7
	1984-85	3,146	970,831	14,103	2,842	3.2	12.3	13.4	13.6
	1989-90	3,674	1,196,612	34,708	6,532	3.4	14.7	15.0	15.1
	1992-93	4,234	1,279,387	56,336	10,799	3.5	14.7	15.3	15.2
500-999	1973-74	963	673,344	2,690	669	1.5	11.6	13.7	14.4
	1979-80	1,152	802,122	6,763	1,500	1.2	10.4	12.9	13.8
	1984-85	1,265	883,348	15,222	3,065	1.3	11.2	14.4	14.7
	1989-90	1,310	1,091,825	37,158	6,962	1.2	13.4	16.1	16.1
	1992-93	1,554	1,085,527	58,465	12,545	1.3	12.5	15.9	17.6
1000-1999	1973-74	524	744,826	3,070	783	0.8	12.8	15.7	16.9
	1979-80	741	1,021,032	8,034	1,769	0.8	13.3	15.4	16.3
	1984-85	609	843,881	15,424	2,803	0.6	10.7	14.6	13.4
	1989-90	611	979,856	38,884	7,901	0.6	12.0	16.9	18.2
	1992-93	598	811,181	46,544	9,426	0.5	9.3	12.6	13.2
2000-4999	1973-74	322	973,485	2,831	892	0.5	16.7	14.5	19.3
	1979-80	399	1,179,866	7,329	1,961	0.4	15.4	14.0	18.0
	1984-85	333	990,632	14,758	2,968	0.3	12.6	14.0	14.2
	1989-90	284	811,731	26,740	6,501	0.3	10.0	11.6	15.0
	1992-93	286	796,291	41,438	8,800	0.2	9.1	11.2	12.4

Employment range (Number)	Factories (Number)	Employees (Number)	Gross Net Value		% Share				
			Output (Rs. Crore)	Added (Rs. Crore)	Factories	Empl- oyees	Gross Output	Net Value Added	
5000&Above	1973-74	75	803,519	1,910	695	0.1	13.8	9.8	15.0
	1979-80	92	1,212,814	6,344	1,947	0.1	15.8	12.1	17.9
	1984-85	103	1,604,868	17,061	4,914	0.1	20.4	16.2	23.5
	1989-90	54	863,023	20,307	5,398	0.1	10.6	8.8	12.4
	1992-93	71	1,225,041	46,270	12,992	0.1	14.1	12.6	18.2
Total	1973-74	64,133	5,820,011	19,568	4,633	100.0	100.0	100.0	100.0
	1979-80	95,126	7,678,271	52,258	10,865	100.0	100.0	100.0	100.0
	1984-85	96,947	7,871,812	105,566	20,887	100.0	100.0	100.0	100.0
	1989-90	107,992	8,142,550	130,659	43,373	100.0	100.0	100.0	100.0
	1992-93	119,494	8,705,047	368,614	71,248	100.0	100.0	100.0	100.0

TABLE 9.5

Structure of Industrial Factory Sector : By Size of Capital

Capital Range (Gross Value of Plant and Machinery)	Factories (Number)	Empl- oyees (*000)	Fixed Capital (Rs. Crore)	Gross Net Value		Percentage Distribution					
				Output (Rs. Crore)	Added (Rs. Crore)	Facto- ries	Empl- oyees	Fixed Capi- tal	Gross Out- put	Net Value Added	
Upto 2.5	1989-90	47,552	1,212	685	9,892	1,770	44.0	14.9	0.6	4.3	4.1
	1992-93	46,406	1,171	812	11,534	2,198	38.8	13.5	0.4	3.1	3.1
2.5 - 5.0	1989-90	15,168	404	593	6,761	901	14.0	5.0	0.6	2.9	2.1
	1992-93	17,155	408	816	9,221	1,166	14.4	4.7	0.4	2.5	1.6
5.0 - 10.0	1989-90	12,188	421	890	8,960	1,253	11.3	5.2	0.8	3.9	2.9
	1992-93	14,398	431	1,076	11,022	1,533	12.0	5.0	0.6	3.0	2.2
10.0 - 20.0	1989-90	8,982	438	1,132	9,808	1,300	8.3	5.4	1.1	4.3	3.0
	1992-93	11,465	473	1,651	14,082	1,787	9.6	5.4	0.9	3.8	2.5
20.0 - 50.0	1989-90	8,318	595	2,381	16,911	2,448	7.7	7.3	2.2	7.3	5.6
	1992-93	10,974	650	3,514	24,874	3,294	9.2	7.5	1.8	6.7	4.6
50.0 - 100.0	1989-90	3,156	374	2,001	12,010	1,940	2.9	4.6	1.9	5.2	4.4
	1992-93	4,660	452	3,307	19,586	2,880	3.9	5.2	1.7	5.3	4.0
100.0 - 200.0	1989-90	2,176	433	2,496	12,630	2,459	2.0	5.3	2.3	5.5	5.6
	1992-93	3,051	480	4,789	19,218	3,171	2.6	5.5	2.5	5.2	4.5
200.0 - 500.0	1989-90	2,053	835	5,535	22,965	4,375	1.9	10.3	5.2	10.0	10.0
	1992-93	2,865	829	9,680	31,988	5,735	2.4	9.5	5.0	8.7	8.0
500.0 - 1000.0	1989-90	1,014	664	5,509	19,588	3,890	0.9	8.2	5.2	8.5	8.9
	1992-93	1,593	745	10,464	32,178	6,306	1.3	8.6	5.4	8.7	8.9
1000.0-2000.0	1989-90	562	588	6,319	19,590	4,387	0.5	7.2	5.9	8.5	10.0
	1992-93	891	649	11,052	32,857	6,516	0.7	7.5	5.7	8.9	9.1
2000.0-5000.0	1989-90	377	474	9,631	23,052	4,677	0.3	5.8	9.0	10.0	10.7
	1992-93	567	571	14,850	36,201	7,642	0.5	6.6	7.7	9.8	10.7

Capital Range (Gross Value of Plant and Machinery)	Factories (Number)	Empl- oyees ('000)	Fixed Capital (Rs. Crore)	Gross Output (Rs. Crore)	Net Value Added (Rs. Crore)	Percentage Distribution					
						Facto- ries	Empl- oyees	Fixed Cap- ital	Gross Out- put	Net Value Added	
5000.0-10000.0	1989-90	153	286	7,839	15,413	3,138	0.1	3.5	7.3	6.7	7.2
	1992-93	244	312	11,691	24,686	5,646	0.2	3.6	6.1	6.7	7.9
Above 10000.0	1989-90	114	1,191	61,622	50,330	10,517	0.1	14.6	57.6	21.8	24.1
	1992-93	230	1,327	118,924	98,445	22,893	0.2	15.2	61.7	26.7	32.1
Unspecified	1989-90	6,179	226	294	2,752	616	5.7	2.8	0.3	1.2	1.4
	1992-93	4,995	207	245	2,722	482	4.2	2.4	0.1	0.7	0.7
Total	1989-90	107,992	8,143	106,928	230,659	43,373	100.0	100.0	100.0	100.0	100.0
	1992-93	119,494	8,705	192,871	368,614	71,248	100.0	100.0	100.0	100.0	100.0

TABLE 9.6
Structure of Ownership of Industrial Factory Sector : 1992-93

	Factories (Nos.)	Employment Work- ers ('000 persons)	Wages per Worker (Rs.)	Net Fixed Capital (Rs. Cr.)	Produc- tive Capital (Rs. Cr.)	Empl- oyments (Rs. Crore)	Gross Value of Output (Rs. Cr.)	Net Value Added (Rs. Cr.)	
Public Sector	7,319	1,760	2,450	35,444	106,117	128,058	10,431	96,533	22,871
Central Govt.	2,139	766	1,052	40,433	51,697	68,376	5,261	58,519	11,685
State or Local Govt.	3,975	898	1,276	31,674	52,365	56,804	4,736	53,195	10,111
Central & State/ Local Govt. Jointly	1,209	95	121	31,419	2,056	2,879	434	4,819	1,074
Private Sector	110,332	4,597	5,847	20,712	75,909	111,192	15,274	244,335	43,812
Corporate	36,827	2,754	3,621	25,963	67,643	102,966	11,751	184,251	36,371
Partnership	47,392	1,175	1,402	11,239	3,473	3,473	1,961	38,587	4,389
Individual Proprietorship	23,516	397	458	9,623	976	976	490	7,635	1,106
Co-operative	2,567	272	366	24,579	3,777	3,777	1,072	13,863	1,946
Joint Sector	1,830	292	407	30,880	10,839	16,101	1,536	27,670	4,560
Central Govt. & Private Enterprises	888	172	239	32,093	6,868	10,844	938	17,099	2,874
State and/or Local Govt. & Private Enterprises	942	119	168	29,123	3,971	5,257	598	10,570	1,686
Unspecified	13	1	1	17,986	6	10	3	76	6
Total	119,494	6,649	8,705	25,056	192,871	255,361	27,226	368,614	71,248

Percentage Share in Total

Public Sector	6.1	26.5	28.1	55.0	50.1	58.3	26.2	32.1
Central Govt.	1.8	11.5	12.1	26.8	26.8	19.3	15.9	16.4
State or Local Govt.	3.3	13.5	14.7	27.2	22.2	17.4	9.0	14.2
Central and State/ Local Government Jointly	1.0	1.4	1.4	1.1	1.1	1.6	1.3	1.5
Private Sector	92.3	69.1	67.2	39.4	43.5	56.1	66.3	61.5
Corporate	30.8	41.4	41.6	35.1	40.3	43.1	50.0	51.0
Partnership	39.7	17.6	16.1	1.8	1.4	7.2	10.5	6.2
Individual Proprietorship	19.7	6.0	5.3	0.5	0.4	1.8	2.1	1.6

Co-operative	2.1	4.1	4.2	2.0	1.5	3.9	3.8	2.7
Joint Sector	1.5	4.4	4.7	5.6	6.3	5.6	7.5	6.4
Central Govt. & Private Enterprises	0.7	2.6	2.7	3.6	4.2	3.4	4.6	4.0
State and/or Local Govt. and Private Enterprises	0.8	1.8	1.9	2.1	2.1	2.2	2.9	2.4
Unspecified	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL :	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

TABLE 9.7

States-wise Net Value Added in Manufacturing Sector : 1992-93
(Rs. Crore at Current Prices)

	Manufacturing	Electricity	Gas & Steam	Storage and Warehousing	Water Works and Supply	All Industries	% to All India
Andhra Pradesh	3,427	865		0.32	5	4,298	6.0
Assam	807	17	7		0.11	830	1.2
Bihar	2,652	777	1	2	2	3,434	4.8
Delhi	1,166	1		4	34	1,206	1.7
Goa Daman & Diu	253					253	4.0
Gujarat	7,027	956	50	0.34	2	8,038	11.3
Haryana	1,623	-7	-7			1,609	2.3
Himachal Pradesh	219	222	1			442	0.6
Jammu & Kashmir	91					91	0.1
Karnataka	3,190	912			19	4,122	5.8
Kerala	1,497	292			25	1,814	2.5
Madhya Pradesh	2,918	983	2	2	4	3,907	5.5
Maharashtra	14,019	2,126	2	29	34	16,210	22.8
Manipur	-3					-3	neg.
Meghalaya	11	20				31	neg.
Nagaland	7					7	neg.
Orissa	1,104	306		1		1,411	2.0
Punjab	1,802	1,122	3	0.47	-0.17	2,927	4.1
Rajasthan	1,659	667		0.10	-0.31	2,326	3.3
Tamilnadu	6,600	702			1	7,303	10.2
Tripura	15	6			1	22	neg.
Uttarpradesh	4,961	1,500	2	15	14	6,491	9.1
West Bengal	3,441	692	0.23	24	17	4,174	5.9
Andaman & Nicobar	20	-10			1	11	neg.
Chandigarh	86				5	91	0.1
Dadra & Nagar Haveli	59					59	0.1
Pondichery	144					144	0.2
All-India	58,796	12,149	61	78	165	71,248	100.0

Table 9.8
Financial performance of centre's public enterprises

Year	No. of Units	Capital employed	Gross Profit before tax	Net Profit before tax	Net profit after tax	Gross profit to capital employed (%) 6 = (3 ÷ 2)	Rate of return Net Profit after tax to capital employed (%) 7 = (5 ÷ 2)
	1	2	3	4	5	6	7
1969-70	73	3,281	139	15	-3	4.2	--
1979-80	169	16,182	1229	255	-47	7.6	-0.3
1985-86	211	42,965	5287	2173	1172	12.13	+2.8
1986-87	214	51,835	6521	3101	1771	12.6	+3.4
1987-88	220	55,617	6940	3353	2030	12.5	+3.6
1988-89	226	67,629	8572	4404	2993	12.7	+4.4
1989-90	233	84,760	10622	5293	3789	12.5	+4.5
1990-91	236	101,702	11359	3820	2368	11.2	+2.3
1991-92	237	1,17,991	13675	4003	2355	11.6	+2.0
1992-93	239	1,40,110	15957	5076	3271	11.4	+2.3
1993-94	240	159,836	18555	6654	4544	11.6	+2.8
1994-95	241	162,457	22630	9768	7178	13.9	+4.4
1995-96	239	173,874	27988	14065	9878	16.1	+5.6

Source : Ruddar Dutt and Sundram; Indian Economy.

UNIT - 10 : PRIVATISATION

Objectives

After reading the unit, you should be able to :

- understand the meaning of privatisation ;
- analyze need for privatisation ;
- understand objectives of privatisation ;
- know different methods of privatisation ;
- get an idea of privatisation in India.

Structure

- 10.1 Introduction
- 10.2 Privatisation - Meaning
- 10.3 Need for Privatisation
- 10.4 Objectives of Privatisation
- 10.5 Benefits of Privatisation
- 10.6 Methods of Privatisation
- 10.7 Privatisation in India
- 10.8 Disinvestment Commission
- 10.9 Summary
- 10.10 Self-Assessment Test
- 10.11 Further Readings

BRAOU

10.1 INTRODUCTION

The reasons for the current spurt in privatisation world-wide have been many. To outline a few, in the aftermath of the external debt crises of the early 1980s and the ensuing years of macroeconomic stability and economic adjustment, many developing countries found it difficult to absorb the fiscal burden of state enterprises. The astounding economic performance of the East Asian countries (with their heavy reliance on outward oriented policies and the private sector) mesmerised many. There was also the major collapse of alternative models of economic development, such as central planning in East Europe, Vietnam and China and other import substitution models of much of Latin America.

In addition, the rapid development of information technologies such as telecommunication, computers, microelectronics, robotics, fibre optics, and advanced and composite materials intensified the competition in global markets. In this world of rapidly evolving technology, the public enterprises failed to keep pace, as their decisions were often politicised and their response to changing markets and technology were sluggish. Also, in many economies public enterprises were overstaffed and depended largely on subsidies and unilateral budget transfers for financial support. As these enterprises were often important suppliers of goods and services to the private sector, their poor performance in turn affected the performance of private firms, particularly in protected markets.

10.2 PRIVATISATION-MEANING

Privatisation is a new word that is rapidly coming into popular usage. The term 'privatisation' has been variously defined. In a limited sense privatisation refers to the transfer of public units to the hands of private sector. But in actual practice, the expression is used in a broader context to embrace a range of alternatives by which state sector is exposed to market forces. The liberalisation policies currently being pursued by countries around the world are interpreted as the task of privatisation. David Herald of the University of Glasgow feels that the term privatisation includes a wide variety of measures; which are considered to roll back the public sector. He identified the following activities as reflective of the policy of privatisation:

- i. substitution of market system of allocation for non-market systems;
- ii. privatisation of production with or without privatising financing; and
- iii. denationalisation and load shedding.

D.R.Pendse, a noted Indian economist, refers to privatisation as any process which reduces the involvement of the state or the public sector in the nation's economic activities. Thus the concept of privatisation is understood in a broad sense to include the following:

1. **Liberalisation** : Privatisation may be used in the sense of liberalisation having fewer controls and regulation by the state, in economic activities. This also means slowing or stopping of new controls and regulation and also dismantling of the existing controls and regulation.
2. **Increase in the Share of Private Sector** : Privatisation may relate to relative enlargement of the share of the private sector in the production of goods and services in the economy. This means faster expansion of goods and services produced by the private sector and slowing down of production of goods and services of the public sector.
3. **Transfer of Ownership** : Privatisation can also be used in the sense of sale of all the shares to the private parties so that public enterprises are converted into private enterprises.

There is some confusion relating to the use of terms like 'privatisation' and 'liberalisation' while the former refers to change of ownership, the latter is often used to suggest change of market structure. In practice, however, the term privatisation is issued in a much wider sense to cover several distinct relationships between the government and the private sector such as denationalisation (sale of public assets), deregulation (introduction of competition into regulated sectors), and contracting out (franchising to private firms of state financed goods and services).

In terms of policy initiative privatisation is generally conceptualised in three broad ways, viz., greenfield privatisation; cold privatisation and divestiture.

1. Greenfield Privatisation

This mode of privatisation includes the following :

- i. Removing barriers of entry into the private sector in any economic activity hitherto reserved for public sector;
- ii. Not allowing any new investment or new activities on the part of the public sector agencies ;
- iii. Preferential treatment being given to the private sector for increasing the level of its activities; and
- iv. In enterprises where private and public sectors have been functioning side by side, such as the joint sector, the relative share of the private sector may be increased.

2. Cold Privatisation

In this type, privatisation is achieved through the following ways:

- i. Giving financial autonomy to seek financial assistance directly from the bank/capital market;
- ii. Giving autonomy to make investment decisions;
- iii. Entering into a Memorandum of Understanding (MOU) for providing freedom to fix prices, output etc.,
- iv. Making subsidies explicit and exhibiting an arms - length relationship; and
- v. Taking recourse to corporatisation, i.e., converting a department enterprise into a corporate entity to ensure distancing.

3. Disinvestment or Divestiture

Disinvestment or divestiture effected by sale or transfer of shares held by the government directly or through its agencies in enterprises to the private sector. When a loss-making enterprise is turned over to the private sector because the government can no longer support and sustain it, this can be termed 'distressed privatisation'.

10.3 NEED FOR PRIVATISATION

Privatisation is necessary and it is not simply to improve the performance of public sector enterprises - though the evidence is striking that it can and does improve performance. Privatisation's essential contributions are to "lock in the gains" achieved earlier in reforming public ownership or in preparing a firm for sale, to distance the firm from the political process, and to inoculate it against the recurrence of the common and deadly ailment of public enterprises: interference by owners who have more than profit in their minds. In practice, however, private ownership tends to produce superior efficiency because of five reasons.

1. **Higher Quality Management :** Private ownership establishes a market for managers, leading to higher quality management.
2. **Private Enterprises are subjected to Scrutiny and Discipline :** Capital markets subject privately owned firms to greater scrutiny and discipline than they do in the case of public enterprises. Because of explicit or implicit guarantees from the state, public enterprises can borrow capital at less than market interest rates. And they often enjoy outright subsidies and other concessions from the state (meaning that they don't pay their taxes, their utility bills, their accounts payable to other public enterprises, customs duties, or the like).
3. **Fear of Closure of Inefficient Enterprises :** Private firms are subject to exit much more often than public enterprises. Private firms are more subject to bankruptcy, liquidation, hostile takeover, and closure than public corporations. When exit is a real possibility, there is a greater likelihood that owners and managers will take active and efficiency enhancing measures to avoid it.
4. **Less Political Interference :** Politicians interfere less in the affairs of private than public firms. Political interference is a major cause of efficiency reducing conditions in public enterprises; it manifests itself in overstaffing, under capitalisation, inappropriate plant location, wrong use of inputs, and many other costly acts.

5. **Self-Interested Owners** : Private firms are supervised by self-interested board members and shareholders, rather than by disinterested bureaucrats, and are thus more likely than public firms to use capital efficiently and to maintain it.

10.4 OBJECTIVES OF PRIVATISATION

The plea for privatisation of public enterprises should not be seen as an independent and isolate decision by itself. It falls in the overall frame work of reduced public interventions, direct and indirect, in order to direct and influence the structure and working of the economy. Withdrawal of direct government involvement in the economy implies a shift towards a philosophy and belief that pattern of new investments and deployment of national productive resources can be left to be determined by the market forces of demand and supply instead of the distortions which follow state interventions. The privatisation policy has to be accompanied by withdrawal of administrative controls, licensing and other policies which restrict free interplay of market economies.

The policy towards reduced role of the State does also suggest that instead of adopting national plan exercises and undertaking large public outlays, the state should basically confine itself to its limited role of maintaining law and order, supplemented by appropriate fiscal and monetary policies to protect vulnerable sections or achieve well defined specific objectives.

Therefore, while the developed countries undertook privatisation to promote competition, which would lead to an increase in efficiency, lower the cost, and raise the quality of goods and services, the developing countries had other major objectives. First, they tried to generate new sources of cash flow and finance for enterprise in both domestic and foreign markets. Second, they tried to reduce governments' fiscal deficit by using privatisation revenues to retire external and domestic debt, reducing fiscal transfers to state enterprises and increasing tax revenues through higher profits generated by privatised enterprises. The following are the main objectives of privatisation:

1. To augment the government resources for other developmental needs and reduce the budget gap.
2. To minimise the requirement of funds from the budget for the inevitable capital requirements of public enterprises.
3. To enable an accelerated growth and diversification of the enterprise under a new environment, which is not constrained by the restrictions normally imposed by public management and accountability.
4. To provide a more efficient management of the organisation, especially in the area of marketing.
5. To reduce the militancy and indiscipline of trade unions that have some political support.

10.5 BENEFITS OF PRIVATISATION

According to a research study conducted by the World Bank on 'Welfare Consequences of Selling Public Enterprises', in Chile, Malaysia, Mexico, and the United Kingdom, divestiture enhanced domestic and world welfare in 11 of the 12 firms analysed, mostly in utilities- the exception was Mexican airlines. The magnitudes of the gains were substantial : they averaged 26 percent of the company's predivestiture annual sales. The following are the benefits of privatisation.

1. **Higher Investment** : Privatisation results in higher investment especially where public enterprises had left demand unmet because of tight budgets. A striking example is Chile, where the telephone company (CTC) doubled its capacity in the four years after divestiture.

2. Higher Productivity : Privatisation may also result in higher productivity as it results in improved labour-management relations and better incentives. Improved productivity may also come from output diversifying in activities previously unexplored, because public enterprise managers either had no incentive to pursue them, or were blocked by bureaucratic restraints from doing so.

3. Higher Output Prices : Another benefit of privatisation is that it results in higher output prices. In case of some products manufactured by public enterprises the prices may be kept artificially low in relation to the scarcity value of resources. The private enterprises may charge the prices on the base of market conditions and hence it may result in higher output prices.

Who Were the Winners and Losers?

Workers : The privatisation may result in lose to workers since some of the workers maybe retrenched. On the other hand, workers also may gain sometimes because of efficient management of the organisation. Workers as participants in the equity of divested firms made substantial gains in the United Kingdom's National Freight, Mexico's Telmex, and Chile's Electricity Distribution Company, Enersis.

Consumers : Consumers may get more benefit, but may not be so all the times. In the majority of cases, consumers were better off after divestiture-thanks to competition and effective regulation. In certain cases, however, consumers as a group ended up worse off. For example, consumers of telecommunication services in Mexico now pay higher prices because tariffs were previously too low to cover costs and allow for expansion. ENERSIS of Chile is a special case. After divestiture, the company reduced theft of electricity significantly, which hurt those who got free power, but allowed lower prices to paying consumers.

Multinational Organisations : Multinational organisations may do well and in the same way national organisations also may get benefit out of privatisation. Multinational companies, according to the survey of the World Bank, profited from divestiture in all but one of the cases where they were involved (Mexicana airlines is the exception). But they were not the only winners- national economies gained as well, because these investors brought in much-needed fresh capital to meet excess demand and growth. This is true, for example, in Mexico's Telmex and Chile's CTC.

Investors : Privatisation may also result in higher returns to the investors and also the sellers i.e., Governments. For example, investors, including may small shareholders in the United Kingdom and participants in pension funds in Chile, came out ahead in every case except Mexicana Airlines. But so did governments in the majority of cases-meaning that the Treasury received more after divestiture in sale proceeds and the discounted stream of taxes than it would have received in dividends and taxes, had public ownership continued. Only in few cases did governments lose and there also only by small amounts.

Activity A :

Do you feel privatisation is the answer for the failure of public enterprises?

Activity B :

State the winners and losers of privatisation.

10.6 METHODS OF PRIVATISATION

As we can notice from the foregoing discussion, even a simple attempt of the government towards liberalisation of the State's regulation and control is interpreted as privatisation. Generally, the following methods are used for the privatisation of public enterprises :

- i. Liquidation.
- ii. Transfer of ownership or divestiture.
- iii. Leasing or employee buy out.
- iv. Transfer of management to private sector.
- v. Contracting out
- vi. Fragmentation.
- vii. Other methods.

1. Liquidation :

Liquidation is simple form of reducing the burden of non-viable public enterprises. Technically speaking, it does not involve any transfer of the undertaking or management into the private hands. As such, liquidation as one of the forms of privatisation may be misleading. However, this is discussed as one of the alternatives of privatisation. In practice, because of the financial and social consequences, governments are reluctant to let big firms close. This is, thus, being considered by the governments only when there is no other way and they want to reduce the fiscal drain, administrative demands and waste of potentially productive resources.

2. Transfer of Ownership :

In fact, privatisation is understood, many a time, in this manner. It is also known as divestiture. This involves the denationalisation and transfer of ownership to the private parties. Both developed and developing countries during their early programmes resorted to this form of privatisation. As early as in 1990s Japanese Government seems to have sold many state firms including 52 factories, 10 mines and 3 shipyards to the private sector. By 1987, the UK Government had raised nearly 21 billion through privatisation of public enterprises. Of this amount, 80 per cent was due to the sale of eight enterprises. Among the developing nations, between 1974 and 1980, Chilean Government sold some 130 state enterprises, with a value of more than 500 million. Besides, more than 250 enterprises (nationalised between 1971 and 1973) were returned to their former owners. Similarly, Pakistan denationalised some 2000 rice, flour and cotton mills, while Bangladesh returned 35 Jute and 23 Textile mills to the private sector. According to a survey in 1987 of privatisation programme in 28 LDCs showed that of their 3,975 public enterprises, 35 were liquidated, 102 were closed and 85 were sold (fully or partially) and 45 were leased or their management contracted out. Thus ownership transfer seems to be one of the most favoured means of privatisation.

The form which ownership transfer can take has profound implications for the methods and procedures which will be appropriate. Usually ownership transfer might take one of the following forms :

- i. Sale of the existing public enterprise as a single unit ;
- ii. Sale of existing public enterprise, having first dismantled it into component parts;
- iii. Sale of shares to the public.

In case of the transfer of ownership, the government in question is required to undergo a hazardous process by way of securing the legislative consent, preparing the public enterprise for disposal and decide about the objectives of the overall privatisation and the mechanics of disposal.

It is not just enough, if the government decides to transfer the ownership. There must be people to acquire the control. Many of the privatisation proposals of the less developed countries are facing rough weather because of the absence of a strong capital market. Public companies are often large and domestic investors may not able to raise enough resources to buy them. On the other hand, selling large public units to those few oligopolists or monopolists who are operating in the market, may strengthen their hands in the market and reduce competition. This may adversely affect the well being of the consumers.

3. Leasing or Employee Buyout :

Another way of privatisation of the public units is to lease the enterprise on certain terms and conditions. The government can charge some lease fee and be free from the risk of running the enterprise. Through this method, the government can temporarily be relieved from the burden and gain time in finding a long term solution to the problems of the enterprise. This form of privatisation is generally preferred where privatisation of ownership is not appropriate.

Acquisition by the management and or workforce of the controlling interest in the enterprises is another form of transferring public interest to the private hands. In countries like India, where the employees resist the transfer of ownership from public to private sector, this can be considered a viable proposition. The management and workers may be encouraged to be owners of the enterprise, so that their commitment may improve in the long run. In fact, leveraged management or employee buyouts (LMBOs) are becoming common in advanced countries. The purchases are being financed by the private and public financial institutions. More so, this alternative may be the only choice when the public enterprise is not saleable otherwise.

4. Transfer of Management to Private Sector or Management Contracts :

Still one more method of privatising the public units is through the transfer of management to the private sector without transferring ownership. For providing management support, the private sector may be compensated suitably. In India, though the entire burden of running the unit is not shifted to the private sector, there were practices of appointing private industrialists as the chairmen and managing directors and also as Board of Directors.

A variation of this practice is to enter into management contract. As the contract is an agreement, both the government and the private sector can specify the rights and obligations of each party, something like memorandum of understanding (MOU) and carry out the job. Depending on the terms of the contract, the management will have full operational control over the enterprise. This can be preferred by the Government when it has not taken a final decision over the selling of the enterprise or it wants to wait and see the reaction of the different interested groups.

5. Contracting Out :

Contracting out is the offering of certain activities, which were supposed to be taken up by the government, to the private parties. Contracting is common in public works, defence and many specialised services. In fact, in the US, the growth of privatisation has been predominantly in the area of contracting out of public services. Urban services such as garbage collection, sewage treatment, solid waste disposal, public transportation and fire protection have been contracted out. In India, contracting is common in respect of public works like laying of roads, construction of dams, bridges, linking of canals etc. While most privatisation activities in the US has so far been concerned with routine housekeeping and infrastructure services, the latest trend is to privatise more sensitive areas such as health and human services and public safety. But the contracting out of these kinds of services is conspicuous by its absence as far as developing economies are concerned.

6. Fragmentation :

This refers to the proceeds of separating the parent entity into several units and each will be privatised separately. For example, a holding company may be reorganised and the subsidiaries may be made independent entities and negotiations may be held for the privatisation of each of the subsidiaries separately. This can be considered as a choice of privatisation under the following conditions:

- i. when there is no one purchaser found for selling the enterprise as a composite unit;
- ii. when the objective is to privatise only certain components of the unit; and
- iii. when the concerned public enterprise is a monopoly and the government thinks that the break up will improve competition.

7. Other Methods :

The choice of mechanics of disposal will depend upon the nature and size of the asset or enterprise involved. The methods so far considered relate to relatively large enterprises. In the case of small enterprises, equity can be sold through a placing with financial institutions. Alternatively, the enterprise or asset might be put up for auction, with the successful bidder being the one meeting any specified conditions which offers the highest price. It is likely to be peripheral assets or subsidiaries which are divested in this way, on the basis that they would not look sufficiently attractive for any other method. In such cases, restructuring would be envisaged for assets which have been neglected. Alternatively, the attraction might be the possibilities for integration with the acquirer's existing business. The possible effects upon competition would have to be monitored carefully, selling a public enterprise to a private competitor would be ownership transfer but might seriously reduce competition.

Activity C

Which method of privatisation you feel is preferable? Why?

10.7 PRIVATISATION IN INDIA

There was no avowed policy of privatising public units owned either by the Central Government or by the diverse State Government. In India, the successive Industrial Policy Resolutions of 1948 and 1956 and later statements of 1977 and 1980 did only specify the co-existence of public and private sectors which would work within the framework of socio-economic policy of the state and subjected the public enterprises to learn from the dynamism of the private sector and the private sector would be urged to embrace the social conscience of the public sector. In that process when the government found that the operation of the private sector entities was leading to the concentration and when it wanted to acquire control over the means of development, it used the stick of nationalisation. But there is nothing said so far as to what is to be done with the erring public sector units.

New Economic Policy : Keeping in view the unprecedented economic crisis and socio-political instability, the Government of India announced New Economic Policy on 24th July, 1991. This policy seeks to drastically alter the economic scenario in our country. The industrial policy statement emphasised the need for the regulation of the Indian public sector. The Government through this policy reduced the number of industries reserved for the public sector from 17 to 6. Even in these six areas private participation will be allowed selectively.

Dilemma in Privatisation : Having invested crores of rupees, the Government is now in a dilemma of whether to close down the units or to privatise them. The question of whether or not to privatise the public units, is not a simple one to be answered straight. One has to consider the problem of employees, their resistance to change, criticism from political parties and the social objectives for which the enterprises are set up.

Considering the precarious financial position, can the Government afford to bear every year the huge losses from the public units? Certainly, it cannot hold any longer the luxury of running public enterprises with their massive losses. The government is finding it difficult to raise resources for meeting various welfare programmes. True, there would be a problem of shift in the pursued economic and industrial policies of the government. But such relaxations would be necessary from the operational point of view and one must consider the cases very objectively. There is no meaning in running these enterprises just for the sake of employees. In the present day context, privatisation of public units seems to be a viable operation for the states to ease their financial and administrative burden.

The moot point here is what type of units should be privatised. Whether all the units that were incurring losses continuously for 5 to 10 years or those units whose net worth became negative. Furthermore, should the losses be the lone criterion for privatisation? Privatisation, cannot be a blanket measure. It should be necessarily selective and the government can privatise its commercial undertakings that were incurring losses continuously. But the transfer of promotional and development corporations cannot be thought off, even though they were incurring losses: for the simple reason that they are established with different objectives and not for profit alone. Similarly, the service corporations like road transport, power and water supply should not be transferred to the private people, since in these cases the service to society being the primary motive. Thus, it would be better, if the policy of privatisation is applied selectively to commercial undertakings, leaving apart the infrastructural, developmental and service-oriented enterprises. As in the case of nationalisation, which is a threat to the private sector, privatisation can be used as a weapon to increase the efficiency of the managements and employees.

Modalities of Privatisation

In the privatisation of public units the government is required to finalise certain modalities. The following are the modalities of privatisation.

- i. It would be better to identify the scope of privatisation in terms of specific units;
- ii. Even in identifying units for privatisation, it is better to treat privatisation as the means to broader objectives of social, economic and financial significance;
- iii. Even when objectives are determined or predetermined and privatisation is considered as a means, it is better to keep privatisation of ownership as one of the options and not the only option, to safeguard the bargaining strength of government with the private corporate sector;
- iv. In prioritising various units, it may be better to initially identify units that are least complicated in terms of being a natural monopoly or core sector, unless there are broader and more important techno-economic criteria;
- v. The preparatory action should involve a clear enunciation of the objectives, provide sufficient flexibility to the committee or officials to consider various packages, and ensure that the concerns of various stakeholders are completely assessed in determining the implementation procedures;
- vi. Even with regard to identifying the party to which the controlling interest is to be transferred, synergy must be considered as an order to optimise development objectives rather than simply return control to the exchequer;
- vii. Continuing the same legal entity has, on balance, proven advantageous if it was registered under the Companies Act;
- viii. The ownership transfer can take place by a variety of methods and over a period of time. The payment terms can also be varied. Flexibility is needed in determining the time of transfer, the mode of transfer and amounts;
- ix. In developing countries a public issue straight away might be difficult. Hence the business house which is likely to have the controlling interest should be identified first;
- x. The transactional arrangement would necessarily involve transfer of control but not necessarily immediately transfer of ownership, provided some financial stake were established through making deposits etc; and
- xi. The arrangements should invariably have penal/contingent provision lest any of the contracting parties fails to discharge their given obligations.

Framework for Privatisation :

The public enterprises in India do not form a homogenous group of similar enterprises. Their performance, market position and public purpose vary widely. These enterprises may be classified into the following :

1. Public purpose served.
2. Extent of resources mobilisation
3. Financial profitability

Based on these three major factors, a three dimensional matrix is developed by the Institute of Public Enterprises, Hyderabad showing high and low for the three components separately, where high means obtaining a positive score in regard to that element by an enterprise and vice-versa.

The three-dimensional matrix for the purpose of arriving at the portfolio for retention is presented in Figure -1.

Figure 1
Three Dimensional Matrix

Factors	High	Low
1. Public Purpose	H_1	L_1
2. Mobilisation of Resource of Financial Institutions	H_2	L_2
3. Profitability	H_3	L_3

It is obvious that if a state enterprise has 'High' score on all the three dimensions (H_1 , H_2 , H_3) it is a fit candidate for being in state sector. While a state enterprise which has 'Low' score on all three dimensions (L_1 , L_2 , L_3) will qualify for drastic action such as closure or privatisation. But all the enterprises do not fall into such convenient categories.

Enterprises which fall under this category are those characterised with high public purpose and low profitability. Many enterprises under this category have been set up especially in the non-industrial sector like promotional, trading, welfare without even the basic procedures of accounting or marketing and personnel management. They would first have to understand that they have to become commercial and not be considered as part of the department.

Obstacles of Privatisation :

One of the greatest obstacles, the Government face in the process of transfer, is the resistance from employees and political parties on their behalf. The employees after serving for many years may not be prepared to lose their non-private status. Some fear about the displacement or retrenchment, since the private entrepreneur may try to prune the size of the undertaking and labour force on economic grounds. Of course, the fears of the employees are genuine and their point of view also require consideration. But the pertinent questions here are: Should the enterprises be run purely for the sake of employees? Are there no alternatives to absorb the employees of a transferred unit in other projects or other departments? The Government can persuade the employees and political parties the necessity for transferring the losing concerns. It can assure the employees that they would be absorbed in enterprises or in the government departments. But there is no point in waiting simply for the cause of employees and spending crores of rupees for no benefit to the society.

Another point which should be considered in the process of privatisation is the objectives for which they are established. In fact, public enterprises have been set up with multiple social objectives and not for profit alone. Public enterprises have been expected to act as model employers, mitigate unemployment, achieve balanced regional development and check concentration of economic power. In case of promotional institutions and service corporations, the provision of social benefits can over ride the profit objectives. But a commercial establishment promoted by the government, in addition to the social objectives, should earn adequate rate of return. If a commercial enterprise incurs losses continuously and becomes a burden to the society, there is no meaning in its continuance under the guise of the social objectives. Instead of wasting public resources in the running of these non-performers, they may be closed or transferred to the private sector.

10.8 DISINVESTMENT COMMISSION

The Disinvestment Commission was set up by Central Government in 1996 under the Chairmanship of distinguished civil servant Sri Ramakrishna. The main objectives of setting up the Commission were to prepare an overall long-term disinvestment programme for public sector undertakings (PSUs) referred to the Commission, determine the extent of disinvestment, select financial advisors to facilitate the disinvestment process, and advise the government on possible capital restructuring to ensure maximum realisation through disinvestment.

Initially, the government referred 40 PSUs to the Commission. Subsequently, some PSUs have been added while some have been withdrawn. So far, the Commission has made recommendations for 53 PSUs. Out of these, the government is yet to take a decision in 30 cases. Of the 33 cases of strategic sale recommended by the Commission, a decision is awaited in 23 cases. Where decisions have been taken, implementation has been very slow. Recently, the Government took a decision of disinvesting 74 per cent of equity in Modern Foods in favour of Hindustan Lever Limited in addition to the decision of disinvesting upto 51 per cent in case of Indian Air Lines and National Fertiliser Limited.

Activity - D

Explain the frame work for privatisation of public enterprises.

10.9 SUMMARY

Privatisation is one of the 'buzz words' today. This unit is devoted to discuss the meaning of the term 'Privatization' and also the need for privatization. What are the objectives with which privatization was initiated, its merits and obstacles to privatization were discussed in this unit. Privatization may be in the form of liquidation, transfer of ownership, leasing or employee buyout, transfer of management to private sector, contracting out or frogmenation - which are known as different methods of privatization. These methods were also explained in this unit.

10.10 SELF-ASSESSMENT TEST

1. Define Privatisation. How do you differentiate between liberalisation and privatisation?
2. Explain the objectives and the need for privatisation of Public Enterprises with particular reference to India.
3. What are the measures of privatisation? Which method is preferable for privatisation of public enterprises in India? Why?
4. State the modalities of privatisation.
5. How do you overcome the obstacles of privatisation in India?

10.11 FURTHER READINGS

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BRAOU

UNIT-11 : SMALL BUSINESS

Objectives

This unit will help you to study:

- the characteristics of small business enterprises;
- definitional aspects of small business enterprises in India;
- policy developments pertaining to small business since independence;
- organisational infrastructure evolved over a period of time, to promote small industry;
- protective policies and incentives currently applicable to small industry;
- growth and problems of small business; and
- recent policy initiatives taken by the Government.

Structure

- 11.1 Introduction
- 11.2 Small Business : Definition
- 11.3 Policy Relating to Small Scale Sector
- 11.4 Organisational Infrastructure for Small Industry Promotion
- 11.5 Protective Policies and Incentive Schemes for Small Industry
- 11.6 Small Scale Industry : Growth & Performance
- 11.7 Constraints and Problems of Small Industry
- 11.8 Summary
- 11.9 Self - Assessment Test
- 11.10 Further Readings

11.1 INTRODUCTION

Small business plays a significant role in industrialised as well as industrialising countries. In industrialised countries it includes small scale manufacturing as well as business establishments. In industrialising countries like India, small business is identified with, what is commonly known as, small scale industry.

Small business attracts the attention of Policy Makers for exclusive promotion all over the world, particularly in industrialising countries because it bestows on an economy several benefits. A small business enterprise :

- is relatively labour intensive and this has implications for equity
- is flexible
- has short-gestation period
- absorbs skilled as well as unskilled labour
- requires less capital to start a unit
- facilitates decentralised industrialisation
- promotes entrepreneurship

- enables technological experiments and innovations.

These features of small business have prompted both industrialised and industrialising countries to formulate exclusive programmes for small industry promotion. In general, the promotional thrust on small business comprises the following :

1. Exclusive laws to define and promote small business
2. Separate apex administrative machinery with regional and sub-regional centres
3. Industrial extension and advisory services
4. Technical services and inputs
5. Financial institutions
6. Fiscal incentives
7. Entrepreneurship development institutes
8. Marketing networks
9. Industrial estates, etc.

Though these form the broad contents of small business development strategy across the world, the relative emphasis varies from one country to another. While industrialised countries encourage competitive growth of small business, in developing countries emphasis is laid on its quantitative growth in a protective environment. Among the developing countries, India has a unique place in small business promotion because of its long standing and comprehensive policies and programmes to protect and promote small business.

11.2 SMALL BUSINESS : DEFINITION

A small business/industry unit can be defined in terms of number of workers employed or amount of investment in plant and machinery or both or in terms of sales. Industrialised countries like Germany and Italy do not have any official definition for small business/industry. China, Sri Lanka and Nepal define small industry in terms of only investment. Japan and Bangladesh define small industry in terms of both employment and investment. In Mexico, it is defined in terms of employment and sales. Malaysia, South Korea and United States define a small enterprise in terms of only employment.

In India, small business sector is nothing but SSI Sector and a unit is defined in terms of investment in plant and machinery. The SSI sector, as of now, covers a wide range of enterprises with diverse characteristics :

1. Small Scale Industrial Undertakings
2. Ancillary Industrial Undertakings
3. Tiny Enterprises

In addition, they also cover Small Scale Service/Business Enterprises (SSSBEs) and Women Enterprises.

Initially, a small industry unit and an ancillary unit were defined both in terms of employment and gross fixed capital (Table-11.1). In 1960, the employment criterion was dropped on the ground that it acts as a disincentive for small industry to generate employment and discriminates against labour-intensive industries. Since then, definition of small industry has been confined to investment alone. In 1960, the criterion was also changed from gross fixed capital to investment in plant and machinery. However, the investment limit on plant and machinery has been increased, from time to time, on two counts: (1) To compensate for the rise in the prices of capital equipments

due to inflation, and (2) To facilitate modernisation.

In 1977, the concept of tiny unit was introduced and was defined in terms of investment (in plant and machinery) up to Rs. 1.00 lakh. The investment limit was enhanced to Rs. 2.00 lakh in 1980, Rs. 5.00 lakh in 1990 and Rs. 25.00 lakh in 1997. The investment limit also applies to a Small Scale Service/Business Enterprise (SSSBE).

A small industry unit is currently defined in terms of investment in plant and machinery not exceeding Rs. 3.00 crore. An ancillary unit is defined as one which caters not more than 50 percent of its production or services to one or more other industrial undertakings and whose investment in plant and machinery does not exceed Rs. 3.00 crore.

If in any of the small scale/ancillary/tiny/SSSBE unit, one or more women entrepreneurs have more than 51 percent financial holding, it will be known as a women enterprise.

Table -11.1
Small-Scale Industry : Definitional Changes

Period	SSI	Ancillary	Employment Criterion
1955	Investment in fixed capital upto Rs. 0.5 million	Investment in fixed capital upto Rs. 0.5 million	Upto 50 workers if using power and upto 100 workers if not using power
1960	Investment in plant and machinery upto Rs. 0.5 million (original value)	Investment in plant and machinery upto Rs. 0.5 million (original value)	Employment criterion dropped
1966	Rs. 0.75 million	Rs. 1.00 million	-----
1975	Rs. 1.00 million	Rs. 1.50 million	-----
1980	Rs. 2.00 million	Rs. 2.50 million	-----
1985	Rs. 3.50 million	Rs. 4.50 million	-----
1990	Rs. 6.00 million	Rs. 7.50 million	-----
1997	Rs. 30.0 million	Rs. 30.0 million	-----

Source : Bala Subrahmanya, M.H: "Shifts in India's Small Industry Policy", Small Enterprise Development, London, Vol 9, 1, March 1998, p-37

11.3 POLICY RELATING TO SMALL SCALE SECTOR

Small scale industry (SSI) has been given due recognition by the Policy Makers in India in all successive industrial policies since independence. The Industrial Policy Resolution (IPR) 1948 underlined the role that small industry can play in generating employment to the large and growing population with scarce capital resources and under developed infrastructure. They not only utilise local resources and absorb local unskilled labour but more importantly enable self sufficiency in respect of essential consumer goods like food, clothing and agricultural equipments.

At the time of India's independence (1947), small scale sector was largely confined to cottage and village industries. It is to promote different segments of small scale sector, traditional as well as modern, that Government of India established six exclusive boards in the course of the first five year plan: All India Khadi and Village Industries Board, All India Handloom Board, All India Handicrafts Board, Sericulture Board, Coir Board and Small Scale Industries Board

(SSIB). The role of Small Scale Industries Board is to promote modern small industry whereas the rest are for promoting traditional industries.

The main requirements of small scale industries during this period, were transformation from traditional methods of production to modern techniques, use of better equipment, machinery and processes, guidance on economic prospects of new and old-product lines, requisite technical know-how, provision of adequate credit at reasonable interest, suitable factory space at reasonable rents and lastly, protection from large scale sector till such time the small scale industries have grown into a viable dynamic and modern sector of industry in the country. In the first phase of small industry development, the accent was, therefore, laid on providing a favourable climate conducive for setting up of new units as well as for modernisation of existing small industry units. Besides, during the first five year plan, the programme of small industry development was conceived mainly to protect the sector from the competition of large scale sector, by providing subsidies and preferential excise duties to small scale sector and imposing restriction on large scale units.

Towards these objectives, the Government set up the Village and Small Industries (VSI) Committee under the chairmanship of D.G. Karve to prepare a scheme, industry-wise and state wise, for the development of village and small industries. The objectives of the scheme were : (1) bulk of the increased production in consumer goods should be provided by VSI; (2) employment provided by these industries should progressively increase; and (3) production and marketing of these industries should be organised on co-operative lines. The Committee suggested, among others: (1) a scheme of concessions and benefits, and (2) reservation of products for manufacturing in the small industry sector. These recommendations led to the implementation of a series of protective measures for small industry growth in the second and third five year plans: reservation of items for exclusive manufacturing in SSI, reservation of exclusive purchasing by the public sector, price preferences, excise duty concessions, concessional finance etc.

During this period, Government of India also invited a team of Ford Foundation Experts to submit a report for small industry development. Based on the Ford Foundation Team's report, a new policy orientation was given to the small scale sector and a positive programme of assistance to small scale industries was formulated to enable them to stand on their own and to strive for continuous improvement in productivity and management. This shift in the emphasis called for an effective countrywide "industrial extension service". It was towards this end that all India Small Scale Industries Board was constituted as an advisory body at the national level to indicate policies for the development of small scale industries. Further, the office of the Development Commissioner (Small Scale Industries) (also known as SIDO) was established in 1954 to coordinate and execute the policies of the Government of India. Under this organisation, four regional institutes called Small Industries Service Institute (SISI) were set up to provide consultancy and extension services to small industry units.

In the course of time, 28 SISIs, 30 branches, 38 extension centres, workshops and laboratories were established across the country.

The National Small Industries Corporation (NSIC) was set up in 1955 to supply machinery and equipment on hire purchase basis so as to facilitate modernisation of plant and equipment in small industry units. The NSIC was also charged with the responsibility of rendering marketing assistance and procurement of Government orders for small scale industries.

The period also saw the launching of Industrial Estates Programme in 1955. The Industrial Estates Programme had two objectives : (1) Promotion of modern small industry through provision of infrastructural facilities and economic incentives, and (2) Dispersal of industries away from metropolitan cities through suitable location of industrial estates in rural and semi-urban centres. An industrial estate is defined as a group of factories constructed on an economic scale in suitable sites with facilities of water, transport, electricity, steam, bank, post office, canteen,

watch and ward and first aid and provided with special arrangements for technical guidance and common service facilities. The programme gained momentum in the second and third five year plans.

Thus, in the first five year plan, strong foundation was laid down for the subsequent development of country wide institutional network for the overall promotion of small industry.

The beginning of the second five year plan coincided with the announcement of the Industrial Policy Resolution (IPR) in April 1956. The Industrial Policy Resolution, 1956 once again emphasised the need for promoting small scale industries, (which remained unaltered in the four successive five year plans) with the following objectives :

- (i) to provide employment opportunity for labour, technical skills, as well as local enterprises at relatively small capital cost.
- (ii) to mobilise un-tapped resources of capital and skill that may otherwise remain unutilised.
- (iii) to meet the substantial part of increased demand for consumer goods and simple product goods, and
- (iv) to ensure more equitable distribution of national income through diffusion of productive industrial activities in large number of hands and counteract tendency towards concentration of economic power by widening opportunities for new and small entrants.

The Industrial Policy Resolution, 1956 kept the entire small industry sector outside the purview of industrial licensing. It also underlined the importance of modernisation and technology upgradation for small industry development.

The Industrial Policy Statement of 1977 laid exclusive thrust on the effective promotion of cottage and small industries widely dispersed in rural areas and small towns. "It is the policy of the government that whatever can be produced by small and cottage industries must only be so produced". The list of industries exclusively reserved for small industry was significantly expanded from 180 items to more than 500 items.

To take away the focal point of development of small and cottage industries from big cities and state capitals to the district head quarters, the policy recommended the setting up of an agency in each district to deal with the all round requirements of small and village industries. This agency is called District Industries Centre (D.I.C). The D.I.C. programme was launched in 1978.

The Industrial Policy Statement of 1980 laid guidelines for strengthening the existing facilities for credit, technology upgradation and supply of critical raw materials.

In July 1991, the Government of India announced the New Industrial Policy which marked the beginning of economic reforms in India. The policy almost abolished industrial licensing, removed restrictions on size and eased the inflow of foreign capital and technology. Simultaneously, tariff and non-tariff barriers on imports of raw materials, intermediates and capital goods were drastically scaled down. This was soon followed by the announcement of an exclusive industrial policy for small industry. Till then, industrial policy for small industry was a part and parcel of the General Industrial Policy of the country. The Small Industry Policy 1991 contained several significant features which indicated that the priority of the Government hereafter, will be to promote competitiveness rather than protect small industry.

- The primary objective of the Small Scale Industrial Policy during the 90s would be to import more vitality and growth impetus.
- The small scale sector (excluding tiny units) would be entitled to one-time benefits (such as preference in land allocation/power connection, access to various facilities, etc.)

- Emphasis to shift from subsidised/cheap credit to adequate credit.
- To enable access to capital market and encourage modernisation and technology upgradation, equity participation upto 24 percent in an SSI unit by a large domestic/foreign enterprise is allowed.
- To overcome the problem of delayed payments by large enterprises, "factoring service" to be introduced through Small Industries Development Bank of India (SIDBI).
- A Technology Development Cell (TDC) to be set up to provide technology inputs to improve productivity and competitiveness.
- Marketing of mass consumption items through common brand names by National Small Industries Corporation (NSIC).
- Industry associations to be encouraged to set up sub-contracting exchanges, common testing facility centres, and technology information centres.
- Premier institutes like IITs will be involved to serve as technology information, design and development centres in their respective areas.

Thus, small industry has increasingly attracted the attention of policy makers of the country since independence. All the industrial policies have recognised the role and importance of small industry in Indian economic development. However, the Small Industry Policy 1991 marks a departure from the past because it lays more thrust on promoting small industry competitiveness, rather than protecting small industry growth, in the period of economic liberalisation.

11.4 ORGANISATIONAL INFRASTRUCTURE FOR SMALL INDUSTRY PROMOTION

India has developed a comprehensive organisational network for the promotion of small industry, over a period of time. The network ranges from national to regional/state and sub-regional/district/cluster levels (Box 1). The objective is to cater to the diversified needs of small industry such as technical inputs and technology, marketing and purchase, research and training, entrepreneurship and management, finance, etc.

1. Policy Formulation & Implementation :

The Government of India has recently formed a separate Ministry for Small Scale Industries headed by a Union Minister of State. Within the ministry, there is the Development Commission for Small Scale Industry (DCSSI) or Small Industries Development Organisation (SIDO).

SIDO is the premier Government organisation for formulating, co-ordinating and monitoring the policies and programmes for the promotion and development of small industries in the country. SIDO has close contacts with all the Central Ministries, Planning Commission, State Government, Financial Institutions, Voluntary Organisations and other agencies related to small scale industries.

At the state level, Directorate of Industries is the apex body for formulating, coordinating and implementing various programmes for small industry development. At the district level, the District Industries Centres (DICs) co-ordinate and implement policies and programmes of the Government. They are also meant for providing different services and support to small scale entrepreneurs under a single roof. As of now, about 430 D.I.Cs are in existence across the country. DICs are jointly sponsored by the Central and State Government.

BOX - 1

Organisational Network and Services for Small Industry

Sl. No.	Activity	National Level	State Level	District/Cluster Level
1	Policy Formulation/ Co-ordination/ Implementation	Development Commission for SSI (DCSSI also Known as Small Industries Development Organisation(SIDO)	Directorate of Industries	District Industries Centre
2.	Technical Inputs, Information and Services	SIDO - Laghu Udyog Samachar	- Small Industries Services Institutes (SISI) and Its branches - State Small Indu- stries Development Corporations(SIDCs)	SISI Branches and Extension Centres
3.	Technology Upgra- dation and Modernisation	Technology Deve- lopment Cell (TDC) of SIDO	- SISIs and branches - State Centres for Technology upgrad- ation	- SISIs, Extension Centres - State Bank of India
4.	Information on Foreign Technology and Facilitating Technology Trans- fer	Technology Bureau for Small Enterprises (TBSE)	State Centres for Technology upgrad- ation	-----
5.	Commercialisation of Indigenous R&D	National Research Development Cor- poration (NRDC)	-----	-----
6.	Marketing Machi- nery on Hire purch- ase, Imported Raw Materials etc.	National Small Industries Corp- oration (NSIC)	- SISIs - State Small Indu- stries Marketing Corporations	- SISIs, Extension Centres
7.	Finance	Small Industries Development Bank India (SIDBI)	- SIDBI Branches - State Financial Corporations(SFCs)	- SIDBI Branches in SSI clusters - Bank branches in SSI concentrated Districts - SFC Branches
8.	Entrepreneurship	National Institute of Entrepreneurship & Small Business Development (NIESBUD)	State Entrepreneur- ship Development Institutes	-----
9.	Training	National Institute of Small Industries Extension Training (NISIET)	-----	-----

Source : From Official Sources

2. Technical Inputs & Services :

SIDO has a network of institutions to provide a comprehensive range of facilities and services including consultancy in techno-economic managerial aspects, common testing centres, technical inputs, etc. This is mainly done through Small Industries Service Institutes, their branches and extension centres, field testing centres, etc. SIDO also publishes a journal - Laghu Udyog Samachar - to disseminate information on various aspects and policies related to small industry.

SIDO has 28 Small Industries Service Institutes (SISIs), 30 branch institutes, 37 extension centres, 19 field testing centres, four regional testing centres and two footwear training centres.

SISIs, branches and extension centres provide the following services :

- technical and managerial consultancy to existing and potential small entrepreneurs
- training programmes on technical and managerial issues
- techno-economic surveys to identify new industrial opportunities
- entrepreneurship development programmes to motivate new entrepreneurs
- common facility services and vocational training in workshops and through mobile demonstration vans
- preparation of reports for modernisation of SSI units in select industries, etc.

3. Technology Upgradation & Modernisation :

Technology upgradation and modernisation of small industry has been emphasised as far in the 1950's, it assumed greater significance since the 80s, especially after the launching of economic reforms in 1991. SIDO has launched and implemented through SISI network - industry specific and cluster specific modernisation programmes in the 80s. But with the introduction of exclusive Small Industry Policy in 1991, a Technology Development Cell was set up in SIDO. At the state level, states like Karnataka and Tamil Nadu have set up Centre for Technology Upgradation in small industry. At the cluster level, State Bank of India in addition to SISI, work for technology upgradation in SSI.

4. Information on Foreign Technology and Technology Transfer :

Technology Bureau for Small Enterprises (TBSE) - jointly promoted by the United Nations Asian Pacific Centre for Transfer of Technology (APCTT) and Small Industries Development Bank India (SIDBI) is an endeavour to bridge the technology gap. The problems faced by small enterprises particularly in accessing technology and enhancing competitiveness have been considerable. Lack of familiarity with new options and inability in accessing them necessitated a form where small enterprises can tap opportunities at the global level for acquisition of technology. TBSE provides such a platform, among others. The Bureau provides information on technology options available from different countries and means of accessing them.

At the state level, State Centre of Technology Upgradation also performs the same function.

5. Commercialisation of Indigenous Technologies :

The Council of Scientific & Industrial Research (CSIR) through its network of laboratories carries out research activities. Those research outputs which are suitable for small scale production are commercialised by the National Research Development Corporation (NRDC). NRDC publicises these commercialised technologies among small entrepreneurs through seminars and exhibitions, through SISIs and other government agencies, in addition to their own publications.

6. Marketing :

National Small Industries Corporation (NSIC) supplies machinery (both indigenous and imported) on hire purchase basis and assists small industry units in getting a greater share of Government purchase. More recently, it has taken initiative to help small entrepreneurs to exhibit their products in international exhibitions as well as to market small industry products in the domestic market under common brand names.

At the state level, several state governments have established small industries marketing corporations. In addition, NSIC caters to the requirements of imported raw materials of SSI through SISI branches and extension centres.

7. Finance :

Small Industries Development Bank of India (SIDBI) is the premier financial institution meant for small industry. SIDBI provides direct as well as indirect financial assistance to small industry units. SIDBI renders direct assistance for specialised marketing agencies, industrial estates, acquisition of machinery, equity capital through soft loan schemes, modernisation scheme, factoring service, etc. SIDBI provides indirect assistance through state financial corporations and commercial banks.

SIDBI has its own network of branches in most states. Recently, it has started setting up branches in SSI clusters as well.

The concept of specialised SSI bank branches has been introduced in the 90s. The objective is to provide focused attention and increased flow of credit to SSI. Commercial banks have operationalised about 400 specialised SSI branches, mostly in SSI concentrated centres/districts.

At the state/district/cluster levels, state financial corporations and their branches also assist small industries through various financial schemes.

8. Entrepreneurship :

National Institute for Entrepreneurship and Small Business Development (NIESBUD) co-ordinates entrepreneurship development programmes organised by entrepreneurship development institutes of different states in the country. The Institute organises and conducts training programmes for motivators, trainers and entrepreneurs and co-ordinates training activities of various institutions, agencies, prepares model training syllabus for various organisations engaged in training activities, etc.

At the state level, many State Governments has set up Entrepreneurship Development Industries (EDIs) to train and promote first generation entrepreneurs for the growth of SSI Sector. These institutes conduct entrepreneurship development programmes in different parts of the respective states periodically.

9. Training :

National Institute of Small Industry Extension Training (NISIET) conducts training programmes in the areas of development, promotion and management of small industries including preparation of feasibility reports, project reports, project management, training methods, etc. The Institute's services are used for consultancy by Central and State Government Departments, Organisations, financial and other related institutions in their programmes for small industry.

Thus, India has developed an elaborate network of institutions and services to nurture, serve and promote small scale industrial units across the country.

11.5 PROTECTIVE POLICIES AND INCENTIVES SCHEMES FOR SMALL INDUSTRY

In addition to the organisational network, Government of India have evolved a number of benefits and concessions, over a period of time, exclusively for small industry (Box 2). These have emerged prior to the launching of economic reforms in 1991, and have been either frozen or relatively diluted in the 90s. However, they still provide some amount of favourable treatment to small industry and thereby imply some degree of protection.

Box 2

Protective Policies and Incentives for SSI

Sl. No.	Policy Measure	Implication
1.	Demarcation through Definition	Eligibility to avail all concessions, benefits and incentives meant for SSI
2.	Priority Sector Lending	Ensures the flow of a certain percentage of bank credit to SSI
3.	Fiscal Incentives	Wide ranging tax benefits. As a result, low or negligible tax payments
4.	Reservation of Items for Exclusive Government Purchases	Assured market for SSI manufacturers of reserved items
5.	Price Preference	If quality is comparable, SSI products are preferred to Large industry products (even if prices of the former are higher than that of the latter to the extent of 15 percent) for Government departments
6.	Reservation of Items for exclusive manufacturing in SSI	Virtually prevents any kind of competition from large scale industry since large units have to export 50 percent of the output if obtained licence to manufacture a reserved item

Source : Extracted from Bala Subrahmanya, M.H. : "India's Small Industry Development Strategy in the 90s : A Review", Sri Lankan Journal of Management, Colombo, Volume 2, Number 2, April - June 1997, p-151.

1. Defining Small Industry :

Small industry (as described in section 11.2) is defined and demarcated from the rest of industry. Only units which come under the category of small scale industry, as per the Government definition, are eligible for official assistance, incentives and concessions. Thus, the definition of SSI is fundamental for the protection and promotion of small industry in India.

2. Priority Sector Lending :

SSI is included under priority sector and credit provided by banks to SSI segment is considered priority sector lending of banks. Commercial banks are required to lend 40 percent of their net bank credit to priority sector including SSI. Further, in order to ensure that banks do not ignore the credit needs for smaller units among SSI, it has been stipulated that banks should lend at least 40 percent of their advances to SSI sector, to those units whose investment in plant

and machinery is upto Rs. 5 lakh, 20 percent to those units whose investment in plant and machinery is between Rs. 5 lakh and Rs. 25 lakh and the remaining 40 percent to those whose investment in plant and machinery is over Rs. 25 lakh.

3. Fiscal Concessions :

Small industry is eligible for various exemptions/concessions in Central Excise Duties, Customs Duties, Sales Tax, etc. Many of these concessions/exemptions are product specific. However, under the General Excise Exemption Scheme, a large number of SSI products get full or partial exemption on the basis of quantum of production.

The units having turnover of less than Rs. 3 crore in the previous year are eligible for exemption on concessional rate of duty in the current year on different production slabs. Full exemption upto Rs. 50 lakh and 5 percent advalorem on the clearances between Rs. 50 - 100 lakh.

4. Reservation of Items for Government Purchase :

The scheme was introduced in 1956 with 16 items but was expanded steadily from time to time to include 409 items in 1984-85. Since then till December 1997 the scheme of reserving items of Government purchase only from small scale industry units by Directorate General of Supplies & Disposals (DGS&D) covered 409 items. The scheme has been rationalised since then and now contains only 358 items.

5. Price Preference :

As per this scheme, wherever the prices of SSI products are higher than the ones offered by medium and large scale enterprises in the context of items reserved for Government purchase, price preference to the extent of 15 percent will be given to the products of SSI over and above the ones offered by the other businesses. The level of price preference is decided by the Directorate General of Supplies and Disposals (DGS & D) and it depends on the quality of SSI goods, among others.

6. Reservation of Items for Exclusive Manufacturing in SSI :

In order to protect small industry from the competition of large enterprises, SSI units have been given exclusive right to manufacture specific products reserved for them. The reservation policy was initiated in 1967 with 47 items but the list was steadily expanded till the late 80s to cover about 836 items. The policy acquired statutory backing under Industries Development & Regulation (IDR) Act in 1984. Non-SSI units can produce a reserved item by obtaining an industrial license, provided they export at least 50 percent of their production. However, large enterprise can participate in marketing the reserved SSI products, without any restrictions.

In 1997, the Government of India have dereserved 15 reserved items and therefore, at present 821 items are reserved for exclusive production in the SSI sector. Of course, product reservation has lost much of its significance, because import of many of these items are now permissible due to trade liberalisation.

On the whole, as of now, though Government policy seems to emphasise the promotion of small industry competitiveness, the element of protection still persists.

11.6 SMALL SCALE INDUSTRY : GROWTH AND PERFORMANCE

Small Scale Industry sector has emerged into a major sector of Indian economy since independence. The growth and performance of the sector can be measured in terms of units, employment, production, relative contribution to total industrial production, exports, etc. The SSI 182

sector has registered phenomenal growth in terms of all these parameters. The figures for the last four decades make it explicit (Table -11.2).

Table - 11.2
SSI Growth : Important Features

Period	No. of Units (in.lakh)	Production (Rs. Crore) (Current Prices)	Employment (Lakh No.)	Export (Rs. Crore)
1966-67	2.50	N.A.	18	68
1976-77	5.92	12400	50	766
1986-87	14.62	72250	101	3643
1996-97	28.57	412636	160	39249

Source : DCSSI

The performance of small scale industry in the 90s is appreciable, particularly relative to that of large scale industry (Bar Chart : A). When large scale industry in India experienced ups and downs in its growth in the 90s, due to competitive environment emerging from economic liberalisation particularly in the early 90s and economic recession pervading world economy in the late 90s, small industry registered consistent growth, be it in terms of units, employment, output or exports (Table - 11.3)

BAR CHART : A

Growth Comparison of SSI Sector and Industrial Sector (in percent)

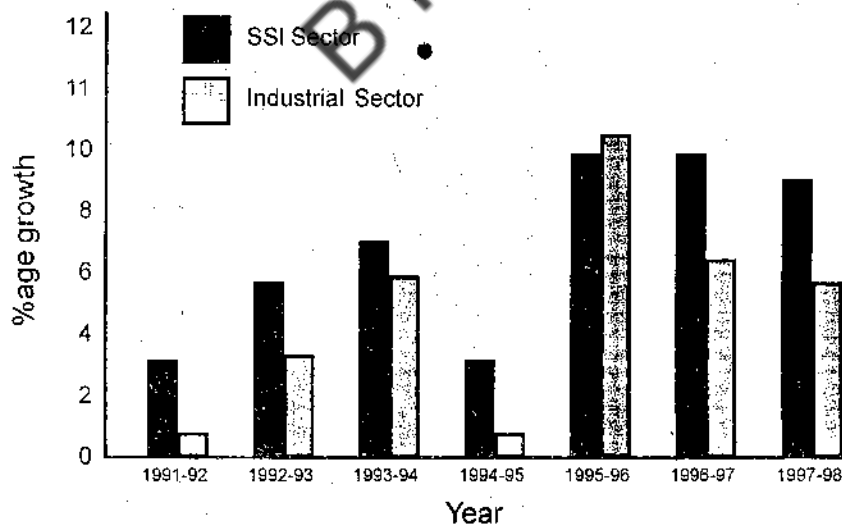


Table - 11.3
SSI Growth in the 90s

Year	No. of Units (Lakh Nos.) (Registered & Unregistered)	At Current Prices	At Constant Prices (1990-91)	Employment Lakh Nos.	Exports (Rs. Crore) (at Current Prices)
1990-91	19.48 (6.86)	1,55,340	1,55,340 (9.46)	125.30 (4.77)	9,664 (26.74)
1991-92	20.82 (6.88)	1,78,699	1,60,156 (3.10)	129.80 (3.59)	13,883 (43.65)
1992-93	22.46 (7.88)	2,09,300	1,69,125 (5.60)	134.06 (3.28)	17,785 (28.11)
1993-94	23.81 (6.01)	2,41,648	1,81,133 (7.10)	139.38 (3.97)	25,307 (42.29)
1994-95	25.71 (7.98)	2,93,990	1,99,427 (10.1)	146.56 (5.15)	29,068 (14.86)
1995-96	27.24 (5.95)	3,56,213	2,22,162 (11.40)	152.61 (4.13)	36,470 (25.50)
1996-97(P)	28.57 (4.88)	4,12,636	2,47,311 (11.3)	160.00 (4.84)	39,249 (7.61)
1997-98(P)	30.14 (5.5)	4,65,171	2,68,159 (8.43)	167.20 (4.5)	43,946 (11.97)

Note : Figures in brackets indicate growth rates with reference to the previous year.

Source : DCSSI

Small industry contributes about 40 percent of the total industrial production of the country. The sector has maintained a consistent growth in production both at current prices and constant prices (at 1990-91 prices). Further, the sector has been identified as a major economic instrument for employment generation. Today, it is the second largest employment generator, after agriculture and its employment is dispersed all over the country, comprising skilled as well as unskilled labour force.

Another significant feature of SSI performance is export contribution. The sector has displayed its vast capabilities consistently, even in periods of adverse circumstances, in the field of exports. Despite constraints such as resource crunch, technology backwardness, growing competition, recurring recession, etc., the sector has increased its share in country's total exports from about 31 percent in 1991-92 to about 35 percent in 1997-98 (Table - 11.4).

Table - 11.4**Share of SSI Sector in All India Exports : 1991-1998**

Year	SSI Exports (Rs. Crore)	All India Exports (Rs. Crore)	Share of SSI (%)
1991-92	13,883	44,041	31.52
1992-93	17,785	53,688	33.13
1993-94	25,307	69,751	36.28
1994-95	29,068	82,674	35.16
1995-96	36,470	1,06,465	34.26
1996-97	39,428	1,17,524	33.40
1997-98	43,946	1,26,286	34.80

Source : DCSSI

Some of the export items where SSI has a significant share are sports goods, readymade garments, wolen garments and knitwear, processed foods, chemical products and pharmaceuticals, leather products, marine products, plastic products, engineering goods, etc., which comprise non-traditional goods and cashew kernel and cashew nut shell liquid, lac, spices, etc. covering traditional items. This implies that even in terms of composition of exports, SSI performance is quite impressive.

Thus today, SSI sector in India is known in terms of its contribution to employment generation, industrial production and export promotion efforts of the country.

11.7 CONSTRAINTS AND PROBLEMS OF SMALL INDUSTRY SECTOR

Though small industry sector has grown remarkably over a period of time, the sector is not bereft of problems and constraints. These problems and constraints broadly, fall under technology, finance, marketing, bureaucratic, infrastructural, etc.

Despite the vast network of Small Industries Service Institutes, industry specific product development centres, etc. the goods produced by small industry are, in general, said to be of poor quality and design. Survey based studies of Entrepreneurship Development Institute of India, Ahmedabad and National Council of Applied Economic Research (NCAER), New Delhi have brought out that SSI products lack quality and the technology in use is obsolete. This could be because, many of the technology development initiatives in the form of setting up the Technology Development Cell in SIDO, Technology Bureau for Small Enterprises (TBSE), Technology Information Centres at the state level, etc. are taken by the Government are only in the 90s. It may be too early to judge the impact of these policies and institutions. Further, the technological transformation of the vast small industry sector is a gigantic task. It will require considerable time, enormous efforts and resources on the part of the Central and State Governments as well as small industry associations.

Non-availability of adequate finance is a perennial problem confronting small industry. Credit demand of small industry can be divided into two: (1) Working capital demand, and (2) Investment demand. The working capital requirements of small industry have been growing 185

considerably due to its consistent growth. The investment demand of small industry has several dimensions: (1) replacement of obsolete machinery or technology upgradation and modernisation, (2) quality improvement, (3) environment related investments, (4) expansion and diversification, etc. Investment demand is likely to assume greater significance, due to economic liberalisation and the resulting competitive environment. The expanding network and responsibilities of Small Industries Development Bank of India, setting up of exclusive SSI branches by commercial banks, etc. are recent but heartening developments towards meeting the ever growing credit needs of the sector.

A small industrial unit is subject to visits by officials of various Government departments such as excise, labour, factory, pollution control, electricity, etc. round the year. The apparent objectives of these visits are to ensure that SSI entrepreneurs follow the rules and regulations applicable to them. But small scale entrepreneurs in the process, are subject to harassment and disturbance. The visit of various inspectors to SSI units for law enforcement is commonly known as "Inspector Raj", and is a major problem affecting small industry functioning.

The SSI sector also faces infrastructural constraints such as shortage of power, poor communication network, etc. even at industrial areas exclusively developed for them including industrial estates.

All or a combination of these sectors have resulted in sickness in small industry. A small scale industrial unit is considered sick, according to Reserve Bank of India, when:

1. any of its borrowal accounts has become "doubtful" advance, i.e., principal or interest in respect of any of its borrowal accounts has remained overdue for a period exceeding 2 1/2 years; and
2. there is erosion in the net worth due to accumulated cash losses to the extent of 50 percent or more of its peak net worth during the preceding two accounting years.

In the case of a tiny unit, a unit may be considered sick if it satisfies the above definition. But in such cases, if it is difficult to get financial particulars, a unit may be considered sick if it defaults continuously for a period of one year, in the payment of interest or instalments of principal and there are persistent irregularities in the operation of its credit limit with the bank.

Sickness in small industry is growing in terms of units as well as amount outstanding (Table - 11.5). However, sick SSI units as a percentage of total SSI units has in fact, declined in the 90s.

Table - 11.5 - Sickness in SSI : 1991-1998

Year	No. of Sick SSI Units	Bank Credit Outstanding (Rs. Crore)	Sick Units as % of Total SSI Units
1991	221472	2792.04	11.36
1992	245575	3100.67	11.79
1993	238176	3442.97	10.60
1994	256452	3680.37	10.77
1995	268815	3547.16	10.45
1996	262376	3721.94	9.63
1997	235032	3609.20	8.22
1998	220594	3843.44	7.25

Source : Hasija, M.M. : "Impact of Economic Reforms on Sickness in Small Scale Industries", Laghu Udyog Samachar, Vol. XXIII, No. 3 to 5, Oct-Dec. 1998.

Several measures have been taken by the Government from time to time for detecting sickness at the incipient stage and towards rehabilitation. To deal with the problems of co-ordination for rehabilitation of sick small scale units, State Level Inter-Institutional Committees (SLICC) have been set up in all states. It provides a useful forum for adequate interfacing between the State Government officials and state level institutions on the one side and the term lending institutions and banks on the other. It closely monitors timely sanction of working capital to units which have been provided term loans by SFCs, implementation of schemes for the rehabilitation of sick units, etc.

In addition, in recent years, the Government has initiated several new measures to overcome the problems relating to technology, marketing and finance :

- SIDBI launched Technology Development and Modernisation Fund Scheme, and Vendor Development Schemes (to encourage SSI vendors/sub-contractors to acquire capital equipment/technology to build up export capabilities/import substitution)
- Towards facilitating Industry Associations and NGOs in the programme of technology upgradation and transfer in SSI, Technology Trust Funds have been created in states with the involvement of State Governments and Industry Associations. The contribution to such funds is in the ratio of 50:40:10 by Centre/State and Industry Associations.
- Testing centres by Industry Associations : The scheme of setting up of testing centre by Industry Association was approved during 1994-95 with a capital outlay of Rs. 1.5 crore with aims to offer improvement, for obtaining ISI mark for their products, to promote standardisation, to provide necessary information on material specification to assist in accreditation for ISO-9000.
- A scheme to upgrade the technology and process of manufacturing in the SSI clusters has been formulated. The scheme also aims at creating cleaner work environment, energy conservation and waste minimisation.
- Enhancement of the limit of composite loan : The limit of Rs. 50,000 for composite loan has been increased to Rs. 2 lakh from September 1997. This limit has further been increased to Rs. 5 lakh in August 1998.
- Working Capital limit enhanced : SSI units requiring aggregate fund based working capital limits upto Rs. 4 crore (raised from earlier limit of Rs. 2 crore) from the banking system will be provided working capital computed on the basis of simplified procedure and on the basis of minimum 20 percent of their projected annual turn over.
- Low interest rate to SSI units with good track record : With a view to moderating the cost of credit to SSI units, banks have been suggested to provide SSI units with a good track record the benefit of lower spreads over the prime lending rate.
- Export Promotion : Various schemes have been formulated to help SSIs in exporting their products. Products of SSI exporters are displayed in international exhibitions. Expenditure on account of space rent, handling and clearing charges, insurance and shipment charges are met by the Government. The trade enquiries generated are widely circulated. To acquaint exporters of the latest packaging standards, training programmes on packaging for exports are organised in various parts of the country.

Thus, in the 90s Government of India have been making concerted efforts to tackle the

problems and improve the competitiveness and dynamism of small industry sector across the country.

11.8 SUMMARY

Small Scale Industry has several features which have endeared the sector to Policy Makers in developing as well as developed countries. India has accorded a place of strategic significance to small industry in the industrialisation process of the country. Elaborate institutions and comprehensive policies have been formed to promote small industry. Due to its own intrinsic strengths and Government policies and programmes, small industry has emerged into a major sector over a period of time. Its contribution to industrial employment, production and exports has been considerably significant. However, the sector has its own set of constraints and problems. In the 90s, due to the competitive environment, these constraints and problems deserved special attention. Accordingly, Government of India has been devising schemes and programmes to overcome these problems and enhance the competitiveness of small industry. An effective implementation of these programmes will have a long lasting impact on small industry performance in the future.

11.9 SELF-ASSESSMENT TEST

1. Analyse the need for promoting small business in a country like India, in the context of its characteristics.
2. Trace the origin and evolution of industrial policy for small industry in India since independence.
3. Discuss the organisational framework and its functions developed over the period, for small industry promotion in India.
4. Examine the dimensions of protection extended to small industry and its relevance in the context of economic liberalisation.
5. Describe the structure and growth of small industry in the 90s with special reference to employment and exports. Discuss the growth of small industry output relative to that of large industry.
6. Analyse the implications of the recent policy initiatives undertaken by the Government of India to facilitate the enhancement of small industry competitiveness.

11.10 FURTHER READINGS

1. Bala Subrahmanya, M.H. : "India's Small Industry Policy in the 90s : Waning Protectionism", Indian Economic Journal, Mumbai, October-December 1999.
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5. Sandesara, J.C., Industrial Policy and Planning : 1947 - 1991, Sage Publications, New Delhi, 1992.
6. Vepa, Ram K. : Restructuring the Institutional Framework for Promoting Small Scale Industries in India, NCAER-FNS, New Delhi, May 1995.

BLOCK - III : ECONOMIC POLICIES

This block discusses and takes a critical look at important economic policies of the Government of India announced from time to time during 1950s to 1990s. It covers policies and legislations which spell regulatory and development roles of the government in the industrial, banking and financial sectors. It also encompasses certain aspects of fiscal policy including budgets of the union government.

The block comprises five units numbered as units 12 to 16. The 1st 2 units (12 & 13) are concerned with industrial policies and their impact on industrial structure and growth of industries as well as overall growth of the Indian economy. In the next 2 units (14 & 15), an attempt has been made to explain monetary and fiscal policies which respectively deal with the RBI and finances of the government. In discussing the industrial, monetary and fiscal policies, the focus is on the recent policies and their implications. The last unit of the Block (unit 16) is related to depiction of banking and financial structure of India and explaining features of recent financial sector reforms.

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UNIT - 12 : INDUSTRIAL POLICIES

Objectives:

On reading this unit, you are enabled :

- To understand the need and scope of industrial policies;
- To assimilate and appreciate the features and imperatives of important Industrial Policies beginning from 1948;
- To examine important legislations related to industrial Policies; and
- To assess the impact of the policies on the industrial structure and growth of India.

Structure

- 12.1 Introduction - Source and Relevance of Industrial Policies
- 12.2 Implicit Industrial Policy during British Raj
- 12.3 The 1st Industrial Policy Resolution of 1948
- 12.4 The 2nd Industrial Policy of 1956
- 12.5 Changes in Industrial Policies - Post 1956 Period
- 12.6 Industrial Regulation - Important Acts
- 12.7 An Assessment of the Impact of the Industrial Policies and Acts
- 12.8 Summary
- 12.9 Self- Assessment Test
- 12.10 Further Readings

12.1 INTRODUCTION - SCOPE AND RELEVANCE OF INDUSTRIAL POLICIES

Industrial Policy in its broad sense refers to the philosophy and principles of industrial development framework visualised by the government. It shapes industrial structure of the country and covers procedures, rules and regulations governing location, size, ownership and management of different types of industries. It also contains roles of public and private sector including foreign capital and relevant aspects of fiscal, monetary and labour policies. In brief, industrial policy reflects concrete decisions of the government as to the way in which it proposes and plans to regulate and develop industries. The relevance of clearly stated industrial policy is self evident. Without a policy, industrial structure and growth will be lopsided and random walking. The policy enables present and prospective industrialists to plan their investments. As India has been following planned development through Five Year Plans, industrial policies form components of the overall development plan of the country.

Before we examine important Industrial Policies, let us note their objectives. As India has been following planned development under Five Year Plans frame, industrial policies were tailored to achieve goals of planning. Therefore, the main objectives of industrial policies are achieving rapid growth, social justice and self reliance through industrialisation.

12.2 IMPLICIT INDUSTRIAL POLICY DURING BRITISH RAJ

You are aware that Britishers ruled India indirectly (through East India Company) and directly for 2 centuries - 1750s to 1950s. During their rule, virtually there was no industrial policy except laissez faire policy. The British Government made India a colony to sub-serve the interests of Britain through procuring cheap raw materials from India and dumping of machine made cheap products in the Indian markets. They killed flourishing cottage, rural, handicrafts and small scale industries. It is worth to remember that before the present European countries got industrialised, India was already industrialised. Its industrial products were in great demand and India was famous for her exports. With the entry of Britishers, a process of de-industrialisation began. After killing the flourishing cottage and small industries, they did not take interest in setting up modern industries. Their aim was to export raw materials from India and facilitate import of British manufactures. It was only under great pressure, the British government was forced to permit establishment of some consumer goods industries and mining from 1850s. India is thus, a century behind in re-industrialisation or modern industrialisation. Notice that England was the first country to get industrialised among the world countries in the 1750s. Further even though in India some large industries were set up from the 1850s, none of them belonged to basic and core industry group, barring TISCO. This was the main reason for the slow growth rate of 1.2% of GDP and 2% growth rate of industry during 1900-47.

Activity - A

Explain scope and relevance of industrial policy.

Activity - B

What did the British Government do with regard to industrial development of India ?

12.3 THE FIRST INDUSTRIAL POLICY RESOLUTION, 1948

On the eve of Independence, Indian economy remained backward, crippled, exploited, dependent and stagnant economy. The newly formed national government faced many problems and many tasks were ahead. There was confusion and uncertainty among industrialists as to the intentions of Government regarding structure and ownership of industries. To remove ambiguity, the Government of India announced the First Industrial Policy in April 1948 which is also called Industrial Policy Resolution. Let us note its main features.

1. India adopted mixed economy setting through this policy. It means that instead of pure socialism or capitalism, a via media or golden mean was adopted. In the mixed economy, public and private sectors co-exist with dominance of the former.

- Industries were classified under 4 categories. In the first category 3 industries, in the second 6 and in the third 18 industries were included. The remaining (other than 3+6+18) industries were included in the fourth category. While the first category industries were reserved fully to central public sector, in the second category all the new units would be set up by the public sector. The existing units under second and third categories may be nationalised. The third and fourth categories though were left to private sector, the government would supervise and regulate them. It was stated that in the next 10 years industries would not be nationalised. After 10 years, if need arises, some of the industries may be nationalised with due compensation.
- The policy recognised the need for foreign capital in industrialising India. However, majority interest in ownership and management in foreign collaborations should vest with Indians.

12.4 THE SECOND INDUSTRIAL POLICY RESOLUTION, 1956

The second industrial policy was announced in 1956 to avoid the threat of nationalisation and to incorporate changes which occurred after 1948. The Constitution of India was adopted in 1950 and the resolution of the ruling Congress Party “socialistic pattern of society” was approved by the Parliament in 1955. The Constitution stipulated directions to the state in the management and ownership of resources. Further, in 1951 the Industries Act was passed and the First Five Year Plan was launched setting broad goals. These changes necessitated announcement of Industrial Policy in more concrete terms.

One important feature of 1956 policy is division of industries into 3 groups or Schedules and defining the respective roles of private and public sectors. In Schedule ‘A’ 17 industries were included and in Schedule ‘B’ 12. Other than these 17 and 12, the remaining industries were left to the private sector including cooperative sector. In the new classification of industries, approximately schedule ‘A’ industries included the former first and second categories, schedule ‘B’ the former 3rd category and schedule C the former 4th category of industries. Schedule A industries shall be exclusive monopoly of public sector. Schedule ‘B’ industries will be progressively state owned. It means that while the units already established in this category would continue to be owned by the private sector, all the new units would be established by the state. This is why schedule ‘B’ is called mixed sector or public-cum-private sector. Schedule ‘C’ industries come under private sector and the government will regulate and develop them as per the 1951 Industries Act.

The policy recognised the importance of private sector and foreign capital in industrialisation. However, participation of foreign capital would be limited and their shareholding would be limited to maximum 40%. Further, the state took the responsibility to rapidly industrialising India. In case private sector does not come forward or not capable of establishing necessary industries, the same will be made good by the public sector. In brief, the 1956 policy accorded supreme role to public sector viz. control over commanding heights of the Indian economy.

Activity - C

Sum up the main features of 1956 Policy and intentions of the Government

12.5 CHANGES IN INDUSTRIAL POLICIES - POST 1956 PERIOD

During the intervening period of post 1956 and up to 1990 June, half a dozen times industrial policies were modified to suit the changing conditions as well as philosophies of ruling political parties. Notwithstanding the changes, until 1991 June, for practical purposes virtually the 1956 Policy continued as base. Therefore, the modifications and changes in the industrial policies will be explained only briefly.

Industrial Licensing Policy, 1970 :

The 1951 Industries Act empowered the union government with vast powers to regulate industries including compulsory licensing of industries. During the course of operation of the licensing policy and working of Industries Act, many irregularities and loopholes in the Act were noticed. They were hotly debated. Noting the criticism and allegations, Government appointed Monopoly Enquiry Commission under the chairmanship of NC Das Gupta in 1964, Dr RK Hajari Committee in 1965 (known as Industrial Planning and Licensing Policy Committee) and Dutt Committee in 1967.

The latter committee under the chairmanship of Dr. Subimal Dutt, which is officially known as Industrial Licensing Policy Enquiry Committee, submitted its Report in 1969 July. Based on its recommendations, a new Industrial Licensing Policy was announced in 1970 February. An important feature of this Policy is division of industries into Core, Heavy Investment, Middle and Unlicensed Sectors. Basic and defense-oriented 9 groups of industries were included in the core sector. Investment of large industrial houses and foreign companies were to be limited to this Core sector, provided the industries do not belong to the reserved list of public sector mentioned in Schedule A of 1956 policy. Industries needing more than Rs. 5 crores investment formed the Heavy Investment sector. In this, private sector was permitted, barring the Schedule A industries. Middle Sector comprises industries needing Rs. 1 crore to 5 crores and for these industries liberal licensing policy would be followed. In the Unlicensed Sector, units requiring Rs. 1 crore investment were included. Another feature of the policy is acceptance of the concept of Joint Sector recommended by the Dutt Committee. It is argued that as a good part of the finances of private sector flows from public financial institutions, the policy suggests that public financial institutions can convert their loans into equity. Therefore, a convertibility clause is to be included while sanctioning financial assistance.

Industrial Licensing Policy, 1973 :

After gap of 3 years, the 1970 Policy was amended in 1973 February. A major change in the definition and also a major concession to MRTP companies are two important features of this Policy. The asset requirement to call an industry as large house or MRTP company was raised from Rs. 20 crores to Rs. 35 crores. The scope of Core Sector was expanded from 9 to 19 industries. A list of 19 industries, comprising Core or those which have direct linkage with Core industries and those having long term export potential, was prepared. As the list was put in Appendix I to the Policy, the industries are known as Appendix I list. The MRTP and FERA companies were allowed to invest in these industries. The appendix list also included low priority industries such as man-made fibres and synthetic detergents.

Janata Industrial Policy, 1977 :

After nearly 2 1/2 decades rule by the congress party, people gave mandate to Janata Party in the 1977 (March) elections. The party experimented with Rolling Plan and announced Industrial Policy known as Janata Policy in 1977 December. As the Janata party was dominated by Gandhians, a distinctive feature of the new Policy is emphasis on growth of small sector. Its

thrust was on the development of cottage and rural industries in small towns and villages. The policy states "whatever can be produced by small and cottage industries, must only so produced". To promote and develop small industries, many measures were announced. The Small Scale Industry (SSI) sector was divided into 3 categories, of which one is Tiny Sector with an investment in fixed capital (building, equipment and machinery) upto Rs. 1 lakh. Reserved list of items to SSI was expanded from 180 to 807 items. It was decided to set up District Industries Centres to provide all services and support needed by the SSI sector under single roof. It created a separate department under IDBI to provide financial assistance. It proposed to strengthen and enlarge operations of KVIC. Under the policy, large scale industries are to be limited to basic industries, capital goods industries and high technology industries. With regard to large industrial houses, it was stated that they should rely on their internal resources to take up new projects or expand existing ones. The role of public sector was expanded from the production of important strategic goods to the supply of essential consumer goods to serve as a stabilising force. As to foreign collaborations, the policy stated that in the sectors where technological know-how was not needed, present foreign collaborations would not be renewed. Except in the case of export oriented and sophisticated technology areas, as a rule Indianisation would be followed i.e. majority interest in ownership and effective control should be vested with the Indian parties.

Activity - D

Briefly sum up Janata Industrial Policy.

The Industrial Policy of 1980

The Janata rule ended in 30 months and the Congress Government with Indira Gandhi as its leader returned to power in 1980. After virtually scrapping Janata policy, its own Industrial Policy was announced in July 1980. Its essence was reiteration of the IPR 1956. The Policy permitted automatic expansion to more number of industries at 5% p.a., regularisation of excess capacity for all the industries in Appendix I of 1973 policy and also to other 15 industries. It stated that 100% export oriented units would be promoted. As a follow up of the 1980 Policy, in the succeeding years (1982-87) changes were introduced by removing further controls and restrictions. The core list was further expanded permitting MRTP and FERA companies. Slowly a sort of privatisation and liberalisation policies ushered in. These changes may be referred to as prelude to the New Industrial Policy of 1991 (which is discussed in Unit 13) or the first phase of liberalisation.

12.6 INDUSTRIAL REGULATION - IMPORTANT ACTS

From the preceding review of Industrial Policies, we learnt the attitude of the government towards development of industries and their regulation, respective roles of public and private sectors, promotion of certain basic industrial and SSI sector, industries opened to large industrial houses and foreign companies. To achieve the objectives contained in the policies, to develop and regulate industries, from time to time the Parliament of India enacted laws. In what follows, some of the important acts dealing with the regulation of industries are outlined.

Industries Act 1951 :

Among the various acts governing industries, the most important piece of legislation is the Industries (Development and Regulation) Act which was passed in October, 1951. The Act came into operation from May 1952. In the very name of the act, the government clearly informed that the aim of the Act was both development and regulation and not primarily control of industries. Notwithstanding the pious intention, in practice it was biased heavily on the regulation and control aspects, in particular on the private sector industries. Other complementary aims of the Act are regulation of industrial investments and production in accordance with the targets and priorities of the Five Year Plans, protection of SSI sector, reduction in concentration of ownership, control of monopolies and balanced regional development. To accomplish the tasks, the act empowered the union government with the powerful instrument of licensing.

- a) There are two parts in the Act. While part one is concerned with development aspects, part two deals with regulatory aspects through the Central Advisory Council and Development Councils for group of industries, development of industries is sought to be implemented. Also government will offer special facilities for the developmet of the scheduled industries.
- b) The Act applies to all the industries included in the 1st Schedule of the Act (initially 37 and subsequently raised to 70).
- c) All existing units are to be registered within a specified period and new units require a licence before they make investment.
- d) Licence is needed not only for a new manufacturing unit but also for substantial expansion (more than 10% of the licensed capacity and since 1966 more than 25% of the capacity). Also license is needed for changing the location and to manufacture a new product.
- e) After submitting application for licence, first a Letter of Intent is issued indicating the conditions and details to be furnished such as foreign collaborations, import intensity of investment and capital issue. If the conditions are fulfilled, Letter of Intent is converted into licence. The licensed unit is to be established within two years from the date of receiving the licence.
- f) The license contains details of the industrial unit to be set up such as location, specific goods to be produced, capacity of plant and machinery, and other conditions.
- g) Before 1964, licence was required when the proposed investment in fixed capital exceeded Rs. 10 lakhs. Subsequently the limits were enhanced to Rs. 0.25, 1.5 and Rs. 15 crores (in the years 1964, 1970, 1978, 1983 and 1988 respectively).
- h) The Act empowers the government to exempt any industry from the scope of the Act. The basis of exemption is size of investment, nature of the industry and foreign exchange requirements.
- i) The government has power to conduct investigation, take over management if the performance is not up to the mark, provide relief or control supply and distribution of the products of certain industries. Investigation is ordered if there has been substantial decline in production levels, deterioration in quality, steep rise in the price of the product or in the case of bad management detrimental to public interest. In extreme cases, registration and licence are cancelled.
- j) Since the 1980s, apart from raising the exemption unit for licensing, many relaxations and exemptions were effected to accelerate growth and efficiency under competitive conditions. These include broad banding, regularisation of excess capacity, automatic permissions for expansion etc. In spite of these relaxations, the licensing system stood as a barrier to entry and growth.

MRTTP Act, 1969 :

One of the goals enshrined in the Constitution (Directive Principles of State Policy) and stated in the Five Year Plans is reduction of concentration of economic power in the hands of a few and, prevention and control of monopoly. The Constitution directs the state that ownership and control of material resources are to be organised to serve the common goal. Further, operation of the economic system should not lead to concentration of wealth including means of production. To realise the objective, the Monopolies Enquiry Committee (Hazari Committee) was appointed by the Government in 1964. It examined the extent and effect of concentration of economic power, prevalence of monopolistic and restrictive trade practices. It submitted first and final Reports in 1966 and 1967. Based on the recommendations as well as to score and edge over the dissidents in the ruling congress party, Indira Gandhi, the then Prime Minister, got enacted the MRTTP bill in 1969 which became operative from 1970. its two main aims reflected in the title are : a) reducing concentration of economic power, and b) prevention of restrictive trade practices with a view to protect consumers from cheating and exploitation. The Act is implemented by a permanent body called the MRTTP Commission. MRTTP companies, otherwise known as Large Industrial Houses, are subject to the Act. The Act defines an MRTTP company as an enterprise or inter connected firms whose assets are at least Rs. 20 crores or with a dominant market share of 33%. Later in 1984 this proportion was reduced to 25%. The Act was amended half a dozen times and the asset limit was also modified in the subsequent years. In 1985 March, the threshold limit of an MRTTP company was raised to Rs. 100 crores. Under the New Industrial Policy of 1991, the threshold limit of Rs. 100 crores was deleted, which means full freedom to MRTTP companies like any other company (we return to this in Unit 13).

FERA, 1973 :

It was noted from 1948 and 1956 Policies that although the government recognised and assigned due role to foreign investment in industrialising Indian economy, majority interest in ownership and management in all foreign equity should be with Indians. It should be noted here that foreign exchange control in India was first introduced in 1939 through Defence of India Rules. Latter in 1947 Foreign Exchange Regulation Act (FERA) was passed as the basic law of exchange control and regulating the operations of foreign controlled companies in India. It was amended in 1957 and 1965. In 1968 Foreign Investment Board was set up to scrutinise and approve foreign collaborations. Banned and favoured lists of industries were prepared. Royalty rates and fees were prescribed. A major change was effected through an amendment which here after will be called FERA 1973, which came into force from 1974 January. The term "FERA company" means any unit with foreign equity subject to the FERA. It put a general ceiling on foreign equity participation with certain exceptions. As per the Act, foreign equity is limited to maximum 40%. If a FERA company does not oblige, it should quit from the country all together. The objective of the ceiling was to limit foreign exchange drain in the form of repatriation of dividends. The Act served as a very important piece of legislation to control the activities of MNCs, flow of foreign capital, technology and managerial enterprise as well as foreign collaborations and joint ventures. In the subsequent years of 1973, many concessions have been given to FERA companies. In Unit 13, we return to FERA companies and the proposed bill entitled "Foreign Exchange Management".

Activity - E

Examine the features of Industries and MRTTP Acts.

12.7 AN ASSESSMENT OF THE IMPACT OF INDUSTRIAL POLICIES & ACTS

So far goals, intentions and features of industrial policies and acts beginning from 1948-1990 were discussed. It is now proposed to assess the implementation of the policies, acts and their impact. The ultimate aim of any policy or development - be it industrial or agricultural - is to raise production and employment and thereby improving living standards of people. Further, the policies also aimed at balanced regional development and self reliance. To what extent these goals are accomplished and what distortions crept into these system? These are answered below briefly.

Through the policies, public sector was assigned the strategic role of "control over commanding heights of the Indian economy" and it was given the task of establishing required industries where private sector did not volunteer to promote them. The government in its anxiety to industrialise the economy, over-controlled, over-administered and over-regulated the industries. Both the public and private sector industries were highly protected under the system of licensing and controls. The licensing system was abused. Large industrial houses were over-whelmingly granted licences liberally. Government did not ensure whether the issued licences were implemented. Members of Parliament and public at large debated and criticised the government for not controlling monopolies and not forcing the licencees to implement the sanctioned capacities. Committee after committee were appointed to probe in to the issues and maladies. Some of the important committees are known with the names of Mahalanobis, Das Gupta, Hazari and Dutt. These Committees collected wealth of data and unambiguously informed increase in inequalities, prevention of potential competitors by various methods, bias in granting licences to large industrial houses, non-implementation of licenses and uncontrolled growth of industries in a few states and areas. Due to lack of competition and transparency, inefficiencies crept into the industries, new technology was not introduced, costs and prices went up.

Deceleration :

The Indian economy and industrial sector seemed to have performed fairly well during the Nehruvian period of 1950 to the mid 60s. After this period, for about one and half decades (mid 1960s to late 70s) deceleration was observed in the Indian economy in general and industries in particular. Various hypotheses were forwarded to explain the deceleration. Two important factors for the decline deserve attention. Public sector investment declined and consequently private sector investment (which moves in tandem with public sector investment) too decreased. This resulted in increased under-utilisation of capacities, in particular capital goods industry. The reasons for decline in the public sector investment were inability of the government to mobilise adequate resources, growth in non-development expenditure and reduction in foreign aid. Also after the mid 1960s, which is called post-Nehruvian period, there was a shift in the State-Society relations. Instead of accent on institutions building and policy; patronage, subsidies and adhocism came into prominence. All these factors led to deceleration in nearly one half of the manufacturing industries. These were heavy, basic and capital goods industries. In contrast, consumer durable goods industry witnessed the fastest growth and after the mid 1960s (and upto the late 70s), it did not exhibit any deceleration signal. Slowed growth of investment and lopsided investment pattern led to skewed income distribution which in turn jacked up durable luxury goods production.

Table 12.1 gives an account of growth of industrial output during 1950-91. Dividing the first 3 decades of planned development into two sub-periods (1950-51 to 1965-66 to 1979-80), one notices deceleration in the industry in particular and economy in general. Average annual growth of industrial output slipped from 6.7% to 4.2% However, from 1980 growth picked up and the average annual growth rate of industrial output rose to 6.8% during 1980-91.

Table - 12.1
Average Annual Growth of Industrial Output and GDP (%)

Period	Industry	Economy
	1	2
1950-51 to 1965-66	6.71	3.44
1965-66 to 1979-80	4.21	3.40
1980-81 to 1990-91	6.78	5.81
Average (1950-91)	5.86	4.33

Source : Calculated from Economic Survey 1998-99

It was stated earlier that during the deceleration period the worst affected industries were basic and capital goods. This may be verified by comparing the growth rates of major groups of industries presented in Table 12.2. Interestingly, in the 4th decade of planning (1980-91), growth picked up tellingly across industries. It may be added that among all groups of industries, relatively faster growth rate was registered by durable consumer goods. While the average growth of all consumer goods as a whole was 6.6% (col. 4. last Row), durable consumer goods grew by 13.7% and non-durables by 5.3% as against the aggregate industrial growth of 6.8%.

Another positive impact of industrial policies and pro-active role of government was on the basic and capital goods industries. An account of the changing composition of the industries in favour of core industries is given in Table 12.3. The relative share of basic industries continuously moved up from 23% in 1956 to, close to 40% in 1980-81. Similarly the share of capital goods industries soared from 4.7% to 16.4% during the same period. It is useful to note that for rapid industrialisation and self reliance, sound base of basic and capital goods industries is essential. Judged from this angle, the industrial policies and the strategic role assigned to public sector fairly succeeded. Broad based rapid industrialisation was achieved. India stood as the lone country with the achievement of near self-reliance among 115 low income countries. Also after overcoming the obsession of the so called Hindu Rate of Growth of 3.5%, India achieved not less than 5% average annual growth during the 5th, 6th and 7th Five Year Plan periods. These are not mean achievements and deserve commendation, notwithstanding misuse of licensing policy, over regulation and failure in curbing monopolistic trends and concentration of economic power.

Table 12.2

Trends in Growth of Industrial Output - Use Based Classification

Period	Basic Goods	Capital Goods	Intermediate Goods	Consumer Goods
	1	2	3	4
1960-65	10.4	19.6	6.9	4.9
1965-70	6.2	(-1.4)	2.6	4.1
1970-76	6.3	6.0	3.3	2.9
1976-80	5.7	4.6	3.5	4.7
1980-91	7.9	11.3	5.9	6.6

(13.7 Durable and 5.3 Non Durable)

Source : CMIE, India's Industrial Sector, 1996

Table 12.3

Trends in the Relative Share of Industries - Use Based Classification (%)

Industry Group	1956	1960	1970	1980-81
		(Base Years)		
	1	2	3	4
1. Basic Goods	23.3	25.1	32.2	39.4
2. Capital Goods	4.7	11.8	15.3	16.4
3. Intermediate Goods	24.6	25.8	21.0	20.5
4. Consumer Goods	47.4	37.3	31.5	23.7
Total (Weights)	100	100	100	100

Source : Reports on Currency and Finance, RBI

Note : In 1980-81, in 23.7% weight of all Consumer Goods, the weight of durables 2.6% points and non-durables 21.1% points

12.8 SUMMARY

Beginning with scope and relevance of industrial policies, first we traced implicit industrial policy of the British government which ruled India for 2 centuries indirectly and directly. It was noted that under the British Raj, flourishing cottage and small industries were destroyed and it was only after a century beginning from 1850s re-industrialisation or modern industrialisation began. Even then on the eve of Independence, barring TISCO, India was not endowed with any basic and heavy industry. After announcing the First Industrial Policy in 1948, it was concretised in 1956 through the Second Industrial Policy. Even after undergoing amendments half a dozen times, up to 1991 June, the 1956 policy served as the base. We reviewed in detail the 1956 policy and others cursorily. Also we discussed a few important acts related to industries such as the

1951 Industries Act, the 1969 MRTP Act and FERA of 1973. Further, an assessment of the industrial policies and acts as well as their impact were studied. It was concluded that contrary to the pious intentions and statements, the Indian industry was over regulated and protected. Inefficiencies increased which led to deceleration after the mid 1960s. From the early 1980s some corrective steps were taken and slowly controls were relaxed and licensing policy was liberalised. Industrial growth picked up. By 1990, notwithstanding distortions and, over regulation and protection, rapid industrialisation was achieved with near self-sufficiency.

12.9 SELF-ASSESSMENT TEST

1. What are industrial policies ? What is the impact of the Policies on the industrial structure and growth during 1950-1990?
 2. Write a note on Industrial Licensing Policy pursued by the government upto 1990.
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12.10 FURTHER READINGS

1. S.D. Sudhanshu, Industrial Licensing Policy and Growth of Industries in India, Deep and Deep, New Delhi, 1986.
2. A. Varshney, "Slow Growth - Deceleration", Economic and Political Weekly, 19(35), 1984.
3. I.J. Ahluwalia, Industrial Growth in India: Stagnation Since Mid 60s, Oxford University Press, New Delhi, 1985.
4. A.N. Agrawal, Indian Economy, Vishwa Prakashan, New Delhi, 1999.
5. Government of India, Economic Surveys, Ministry of Finance, New Delhi, 1980s.

UNIT - 13 : NEW INDUSTRIAL POLICY, 1991

Objectives

After reading this unit, you will be able to :

- Comprehend circumstances under which the New Industrial Policy was announced together with complementary other liberalisation policies;
- Understand the salient features of the Policy and subsequent changes; and
- Assess the impact of the Policy on rate and pattern of industrial growth in particular and the economy in general.

Structure

13.1 Introduction - Crisis of 1991 and Conditions Under Which the New Industrial Policy was Announced

13.2 Exchange Rate and Trade Liberalisation Policy

13.3 Salient Features of the New Industrial Policy of July 1991 and Subsequent Changes

13.4 An Assessment of the Policy and Impact

13.5 Summary

13.6 Self-Assessment Test

13.7 Further Readings

13.1 INTRODUCTION : CRISIS OF 1991 AND CONDITIONS UNDER WHICH THE NEW INDUSTRIAL POLICY WAS ANNOUNCED

You are aware that the Congress party was returned to power at the centre in the General Elections of 1991 June with PV Narasimha Rao as its leader. On assuming the reigns of the government, the Rao government felt that India was under a deep crisis. The crisis did not occur over night. It was the cumulative impact of misdeeds, mis-planning and squandering of resources beginning from Indira Gandhi and her successors. The bureaucracy was equally responsible for mis-guiding the people and non-transparency. The crisis faced in 1991 was un-precedent. A host of factors contributed to it. It was basically an outcome of structural maladies of the Indian economy. The Gulf War of 1991 further aggravated the problem. It was centered in balance of payments and government finances and not so much in agriculture or industry. India was unable to honour her external obligations and she lost credibility before the foreigners. Even the NRIs, losing faith in India's creditworthiness, started withdrawing their deposits abruptly. Forex reserves dwindled to the lowest - just equal to the value of two weeks of imports. Imports exceeded exports by about Rs. 10,000 crores and current account deficit shot up to about 3.5% of GDP. Fiscal deficit, a measure of government current indebtedness, rose to 8.4% of GDP. Inflation by August 1991 soared to 15%. All these are symptoms of bad finance of the government and weak balance of payments status of India. To overcome the crisis and set right the Indian economy, the government thought that the only option was to seek assistance from international financial institutions. The important institutions are IMF and IBRD (the latter is popularly known as World Bank). When approached, the institutions promised immediate and medium term help. However, they pointed out that due to over-spending and over regulation, the Indian economy

has been plagued by chronic malady. Therefore, unless the chronic disease is cured, any amount of external financial assistance would not solve the problem. While giving assistance, the Fund - Bank twins suggested a remedy or gave suggestions or imposed conditions. The suggestions or conditions may be represented by 4 "Ds" viz. Devaluation, Deflation (through reduced spending of the government including on subsidies), Denationalisation (Privatisation), and Deregulation/Delicensing.

Taking the advice into account and taking into consideration the prevailing situation, India went on effecting a number of sweeping radical changes in its policy. These changes are known with different names. Some of them are : Stabilisation and Structural Adjustment Programme (SAP), New Economic Policy (NEP), Recent Economic Reforms and New Industrial Policy (NIP). The essence of all these policies is Liberalisation with the complements of Privatisation, Marketisation and Globalisation. As this Unit is concerned with NIP, we will only touch upon other complementary policies and concentrate on the ingredients of the NIP.

13.2 EXCHANGE RATE ADJUSTMENT AND TRADE LIBERALISATION POLICY

As a prelude to the New Industrial Policy, first the exchange rate was adjusted downwards (on the assumption that Rupee was over-valued) to have competitive rate of exchange. On 1st and 3rd July 1991, Rupee was devalued by 17% to 19%. To be sure, before devaluation Rs. 21=\$ 1 and after devaluation the rate became Rs. 26=\$ 1. This was the third time for independent India to devalue (the first two devaluations were effected in 1949 & 1966). It is to be noted that it is only when certain conditions are fulfilled, devaluation encourages exports and discourages imports in the short run.

International trade, in stages beginning from July 1991, was liberalised. India's foreign trade has been extremely regulated with the instruments of permits, licenses, controls, orders and quantitative restrictions. Under the policy, most of them were either abolished or drastically reduced. To facilitate foreign transactions, in stages, Rupee was made convertible on current account by 1994. It means that for exports and imports, travel, interest and dividend etc. transactions, Indians can freely convert Rupee into foreign currencies and vice versa with minimum regulations. With this introduction, we now proceed to understand and appreciate salient features of the NIP.

13.3 SALIENT FEATURES OF THE NEW INDUSTRIAL POLICY OF JULY 1991 AND SUBSEQUENT CHANGES

The New Industrial Policy was announced on 24th July, 1991. This policy and other liberalisation policies are premised on the assumption that Indian economy and more so Indian industry were highly protected and over regulated. Due to lack of competition, internally and externally, Indian industry became inefficient and high cost. The public sector and the private industries were described as "Caged Tigers". The purpose of NIP was to liberate the so called tigers and make them to compete both within (India) and outside (abroad). It is assumed that when industries operate under competitive conditions, for survival and growth, industries strive for efficient production by improving technology, minimising wastage, reducing costs and prices as well as improving quality. Therefore, the new government under PV Narasimha Rao, announced a number of sweeping changes in the industrial policy. We now study each one of the main features individually at some length.

1. Public Sector - Reduced Scope and Role :

In Unit 12, you noted that 17 industries mentioned in Schedule 'A' were reserved to public sector. Under the New Policy, first the number of industries reserved to public sector was reduced to 8 and later to 6. It means that 11 industries which were hitherto monopoly of public sector were thrown open to the private sector. The 6 industries are : Arms and Ammunition (defence industries), Railways, Coal, Mineral Oils, Atomic Energy and Minerals needed for atomic energy (uranium, plutonium etc). Not only its scope was sized down, its role was also reduced. Today public sector is no more given the role of "control over commanding heights of the Indian economy". Its role is not so much resource allocation but mainly to serve as Facilitator, Enabler, Coordinator and help industries by providing adequate infrastructure with necessary institutional arrangement. Further, wherever the economic activity is not viable or where losses are occurring, public sector should quit. Role of public sector in this context is to be interpreted to include role of government as well as Planning Commission.

In the recent two years, even coal industry, which was reserved to public sector, is partly de-reserved by way of allowing private sector to take up new mines. In the budget of the BJP government for 1999-2000, it was announced that both general and life insurance would be partly de-nationalised. With the implementation of this proposal, new private organizations already entered into Indian Insurance market.

2. MRTP and FERA Companies :

It was noted earlier (Unit 12) that with a view to arrest monopolies and conserve forex reserves, MRTP Act and FERA were passed. Even though beginning from the 1980s relaxations were announced giving freedom to MRTP and FERA companies, still many restrictions were existing. Under the NIP, these companies are liberated by diluting most of the provisions contained in the 1969 MRTP Act and 1973 FERA. They are now free to take up a variety of economic activities and industries like other undertakings. The threshold limit of Rs. 100 crores was removed by amending the 1969 MRTP Act. As the 1973 FERA was amended drastically to give more freedom to FERA companies (MNCs etc.), the Government of India decided to replace FERA by a new bill called Foreign Exchange Management Act (FEMA).

Foreign Exchange Management Act

In view of the fact that beginning from 1991 as number of concessions were given to FERA companies, they are now almost on par with Indian companies. Therefore, the government decided to replace FERA by a new act called FEMA. In the union budget 1998-99, government advocated replacement of FERA by FEMA. Accordingly in August, 1998 Foreign Exchange Management Bill was introduced. As the name suggest, the emphasis on management rather than regulation of foreign exchange and foreign companies. The Bill aims at consolidating and amending the law relating to foreign exchange to facilitate external trade, payments and promotion of orderly development of foreign exchange markets in India. It contains details about the way in which current capital account transactions will be regulated, repatriation of foreign exchange, penalties, adjudication and appeals. Subsequent to the introduction of the bill, many criticisms were levelled. The Bill was referred to Parliamentary Standing Committee in December 1998. FEMA has come into operation from 1st June 2000.

3. De-Licensing :

You noted earlier that the 1951 Industries Act bestowed the Union Government with vast powers to regulate and license industries. Licensing is an instrument to regulate location of industries, size and nature of industries to be established. Without licence, no important industry can be established. The system was a barrier on entry and fair competition. Therefore, under the New Industrial Policy, in stages de-licensing was implemented. The number of industries requiring licence was initially limited to 18 which subsequently was further slashed. With effect

from 1998-99, only 5 industries need licences. These are hazardous, polluting, and defence related industries. At present industrialists have freedom to choose any location other than cities with 10 lakh population. Even in such cities non polluting industries such as software and electronics can be set up. Also in the existing industrial estates, even polluting industries can also be established.

4. High Priority Industries - Foreign Equity Participation :

The government prepared a list of industries which initially included 35 industries. In these industries, foreign direct investment is approved automatically through RBI route up to 51%. The industries included under high priority need huge investment and modern technology. For the industries other than the listed 35, foreign direct investment is considered case by case. Also if the foreign equity is beyond 51%, permission of the government is needed. In the recent years, to further liberalise foreign direct investment, the number of industries raised to 60 wherein foreigners can invest upto 51% without taking prior permission. In December 1996, government permitted automatic approval of foreign direct investment upto 74% for 9 types of industries. Also upto 50% automatic permission is given to 3 more industries in mining. Foreign Direct Investment (FDI) approvals have sectorial caps - 20% in banking (for NRIs 40%), 51% for non-banking companies; 49% in telecommunication, 40% in domestic airlines (100% for NRIs), 51% in drugs, 50% in mining except in gold, silver, diamonds and precious stones; 100% in power, roads, bridges, ports and harbours, tourism, petroleum and venture capital funds. In brief, FDI can now freely flow into many economic activities of India.

5. Dis-Investment or Partial Privatisation :

Not only the areas of operations of public sector were pruned to 6, in most of the existing public sector industries and undertakings the government started divesting a part of its share holding. Through divestiture of shares owned by government, public enterprises are converted into joint sector units. Off loading of equity has been taken up in stages both in commodity producing industries and service units. The latter include nationalised banks. The broad principle in dis-investment is that the government should gradually hand over ownership and management of a large number of industries to private sector. It is decided that generally the government will offload (sell away) 49% of its shares in core industries and 75% in non-core units. In other words, ownership of the government will be limited to 51% and 24% respectively. It is assumed that partial entry of private sector into public sector transforms the units to joint sector which will improve management and efficiency. At the same time, the resources obtained through dis-investment would be more profitably used by the government in other essential areas. Beginning from 1991 to 1998-99, close to Rs. 18,300 crores dis-investment was undertaken and the 1999-2000 budget set Rs. 10,000 crores as dis-investment target.

Other Methods of Privatisation :

In the recent decade of liberalisation, government has been adopting other methods of privatisation viz. BOO, BOT, BOLT, BOST. Under BOO (Build, Own and Operate), new units hitherto undertaken by the public sector are given to private sector. Under Build Own and Transfer, private sector invests, operates for sometime and later transfers to government after paying due amount. In the case of Build Own Lease and Transfer, the private sector invests and leases to government as in the case of construction of railway line in certain areas. After sometime, the private sector transfers to government the ownership after receiving compensation. BOST means Build, Own, Share and Transfer. In this private sector invests, owns, shares with the government for sometime and subsequently transfers unit to government after receiving the cost.

6. SSI Sector :

To strengthen Small Scale Industries (SSI), the United Front Government in 1997 increased the ceiling of SSI fixed investment (in machinery, equipment and building) was raised to Rs. 3 crores from Rs. 60 lakhs. At the same time for tiny sector the limit was raised from Rs. 5 lakhs to Rs. 25 lakhs. The number of items reserved to SSI sector was reduced from 836 to 812 in 1998-99. In December 1999, the BJP government reduced the enhanced ceiling from Rs. 3 crores to Rs. 1 crore. It is argued that as most of the SSI units have an investment of less than Rs. 1 crore, the concessions which are given to the SSI sector need not be given to relatively higher investments SSI units. This is why SSI units are now defined as those industries whose investment is not more than Rs. 1 crore. To enable the SSI sector to acquire modern technology, the NIP permits investment upto 24% by any type of person including millionaires of India or foreigners.

7. Under the old policy, foreign collaborators were required to follow Phased Manufacturing Programme (PMP). Under the NIP, PMT is abolished which means indigenisation in manufacturing will not be insisted upon. Further, prior to the NIP, banks and financial institutions while lending to private sector were permitted to include convertibility clause in the agreement. The clause enables the financier to convert part of the loan into equity. Despite the clause, in practice generally it was not implemented. Under the NIP, the financial institutions will not impose the mandatory convertibility clause. To improve profitability of industries, corporation tax was reduced to 35% on domestic companies and to 48% on foreign companies.

8. To regulate sale and purchase of shares, and minimise the control of the government in the stock markets, Securities Exchange Board of India (SEBI) was established in 1988 as a non-statutory body. It was conferred statutory power by the SEBI Act of 1992. Controls over price and premium on shares were removed. Export Processing Zones (EPZs) and Free Trade Zone (FTZs) are being encouraged. With effect from July, 1999 it was decided to convert all EPZs into FTZs on lines of those existing world over.

Activity A :

1. Recollect and write down the circumstances which led to the New Industrial / New Economic Policies.

Activity B :

2. Write a brief note on the salient features of New Industrial Policy of 1991 and the subsequent changes.

Table 13.1
Trend in Growth Rates of Indian Economy
Pre & Post - Liberalisation Periods
(@ 1980-81 Constant Prices, % p.a)

Year	Agriculture	Industry	Services	GDP
	1	2	3	4
Pre-Liberalisation				
1985-86	0.4	4.5	7.4	4.1
1986-87	(-)1.0	6.9	7.6	4.3
1987-88	0.5	6.6	6.1	4.3
1988-89	16.3	8.7	7.3	10.6
1989-90	2.0	10.5	9.0	6.9
1990-91	4.2	7.0	5.4	5.4
<hr/>				
1985-91 Average	3.9	7.4	7.1	5.9
<hr/>				
Post-Liberalisation				
1991-92	(-)2.0	(-)1.7	5.1	0.8
1992-93	5.8	4.4	5.5	5.3
1993-94	3.5	7.1	7.4	6.0
1994-95	4.8	9.5	7.6	7.2
1995-96	(-)2.7	11.9	9.0	7.6
1996-97	9.1	5.6	7.4	7.8
1997-98	(-)6.0	6.6	9.1	5.8
1998-99	7.2	4.4	5.8	6.8
<hr/>				
1991-99 Average	2.5	6.0	7.4	5.8

Source : Reports on Currency & Finance, RBI

Note : Industry includes Manufacturing, Electricity, Gas, Water Supply and Construction.

Table 13.2

Trend in Rates of Inflation - Pre & Post Liberalisation Periods (%)

Year	WPI		Consumer Price Index	
	Industrial Workers		UNME	Agl. Labour
	1	2	3	4
Pre-Liberalisation				
1985-86	5.7	6.5	6.8	5.9
1986-87	5.3	8.7	7.9	3.1
1987-88	8.2	8.8	9.6	10.0
1988-89	7.5	9.4	7.9	12.6
1989-90	7.4	6.1	6.6	5.4
1990-91	10.3	11.6	11.0	7.6
1985-91 Average	7.4	8.5	8.3	7.4
Post-Liberalisation				
1991-92	13.7	13.5	13.7	19.3
1992-93	10.1	9.6	10.4	12.3
1993-94	8.4	7.5	6.9	12.5
1994-95	10.9	10.3	9.5	12.2
1995-96	7.8	10.0	9.5	10.7
1996-97	6.4	9.4	9.3	9.0
1997-98	4.8	6.8	6.9	3.4
1998-99	6.9	8.3	7.2	3.8
1991-99 Average	8.6	9.4	9.2	10.4

Source : Reports on Currency & Finance, RBI.

Table 13.3
Relative Shares of Public & Corporate Private Sector
In Total Employment of Organised Sector (%)

Year (end Dec)	Public Sector	Private Sector	Total
	1	2	3
1982-83	69.4	30.6	100(24.1)
1983-84	70.1	29.9	100(24.6)
1984-85	70.3	29.7	100(25.0)
1985-86	70.6	29.4	100(25.1)
1986-87	71.2	28.8	100(25.6)
1987-88	71.3	28.7	100(25.9)
1988-89	71.3	28.7	100(26.0)
1989-90	71.3	28.7	100(26.4)
1982-90 Average	70.7	29.3	100(25.3)
1990-91	71.3	28.7	100(26.7)
1991-92	71.0	29.0	100(27.1)
1992-93	71.1	28.9	100(27.2)
1993-94	71.0	29.0	100(27.4)
1994-95	70.7	29.3	100(27.5)
1995-96	69.5	30.5	100(27.9)
1996-97	69.2	30.8	100(28.2)
1997-98	68.7	31.3	100(28.4)
1990-98 Average	70.3	29.7	100(27.4)

Source : Reports on Currency & Finance, RBI

Note : Figures in Parenthesis are persons employed in millions.

Table 13.4
Trends in Employment Growth
In the Organised Sector (%)

	Growth of Employment			Growth of Unemployment
	Public Sector	Private Sector	Total	
	1	2	3	4
1983-84	2.8	(-)0.5	1.8	7.3
1984-85	3.4	1.0	1.8	11.6
1985-86	0.5	(-)0.7	0.2	14.7
1986-87	3.1	0.2	2.3	0.4
1987-88	1.4	0.9	1.2	0.8
1988-89	0.1	(-).Neg	0.1	7.5
1989-90	1.4	1.7	1.5	5.7
1983-90 Average	1.8	0.6	1.3	6.9
Post-Liberalisation :				
1990-91	1.5	1.2	1.4	4.8
1991-92	0.8	2.2	1.2	1.3
1992-93	0.6	0.1	0.5	(-)1.3
1993-94	0.6	1.0	0.7	1.3
1994-95	0.1	1.6	0.6	1.9
1995-96	(-)0.2	5.6	1.5	4.6
1996-97	0.7	2.0	1.1	2.8
1990-97 Average	0.6	2.0	1.0	2.2

Source : Reports on Currency & Finance, RBI

Table 13.5

Growth Rates of Employment in Manufacturing and Industries (% p.a.)

Year (end Dec.)	Manufacturing	Industry
	1	2
1983-84	(-)0.3	1.1
1984-85	1.6	1.4
1985-86	(-)0.5	0.2
1986-87	(-)0.1	(-)0.1
1987-88	(-)0.4	1.2
1988-89	0.2	(-)1.3
1989-90	1.5	(-)8.2
1983-90 Average	0.3	(-)0.8
1990-91	(-).Neg	11.1
1991-92	1.5	1.1
1992-93	(-)0.5	(-)0.2
1993-94	0.3	0.4
1994-95	0.8	(-)1.6
1995-96	5.0	5.4
1996-97	1.7	0.7
1990-97 Average	1.3	2.4

Source : Reports on Currency and Finance, RBI

Table 13.6
Growth of Employment in the Indian Manufacturing
(Organised, Unorganised & SSI Sector) (% p.a.)

Period	Organised Manufacturing	Unorganised Manufacturing	SSI Sector	Total
	1	2	3	4
1973-78	4.9	6.2	8.0	5.8
1978-83	1.9	3.7	7.9	3.2
1983-88	(-)0.5	4.0	6.3	3.0
1988-94	2.3	1.1	4.5	1.3

Source : B. Goldar, "Employment in Industry"; Institute of Economic Growth, Delhi, 1998 (mimeo).

Table 13.7
Proportion of People Below Poverty Line

Year	Rural	Urban	Total
	1	2	3
Pre-Liberalisation			
1983 @	45.7	40.8	44.5 (323)
1987-88 @	39.1	38.2	38.9 (307)
1988-90 (b)	33.7	36.0	34.3 (276)
1990-91 (b)	35.0	35.3	35.1 (291)
Post-Liberalisation			
1992 (b)	41.7	37.8	40.7 (348)
1993-94 @	37.3	32.4	36.0 (321)
1994-95 (b)	38.0	34.2	37.0 (330)
1995-96 (b)	38.3	34.0	36.1 (328)
1996-97 (b)	38.5	34.0	37.2 (349)
1997-98 (b)	45.2	34.6	43.0 (406)

Source : NSSO Estimates and Planning Commission of India.

Note : @ Estimates are based on Large Sample Data, (b) estimates are based on Thin Sample Data. Estimates for 1998 are for 6 months.

Having understood the aims and main features of NIP and related liberalisation measures, it is now relevant to assess its performance and impact.

13.4 AN ASSESSMENT OF THE POLICY AND IMPACT

There cannot be two opinions regarding the relevance and need for the liberalisation policies including the NIP. They were overdue. Criticism is levelled against the bunching, intensity, sequence and timing of the policies and associated measures. It is difficult to assess and quantify the impact of only NIP in isolation. Along with the NIP, other sectors of the economy have been freed to face national and international competition. Therefore, the assessment and impact quantification being undertaken now are with regard to the reforms as a whole in general and the industrial sector in particular.

Undoubtedly, the policies succeeded in solving the crisis of 1991 and restored quickly credibility of India. Current account deficit has been contained to 1% to 1.5% GDP and adequate forex reserves were built up (in Jan 2000 over \$32 billions). India is able to attract FDI and portfolio investments from abroad in various industrial activities including power generation. Fiscal deficit was brought down to around 5% of GDP. There are winners and losers in the aftermath of the liberalisation policies. Qualitative and structural changes occurred. Not all industries or sectors gained. The policies are not unmixed blessings. With this caution, let us now quantify the impact in terms of select variables. For comparison, we divide the period between 1982 or 1985 to 1998 into two sub-periods with the cut-off year of 1990-91, for the NIP was announced in July 1991. The 1st sub-period is called Pre-Liberalisation and the 2nd period (beginning from 1991-92) Post-Liberalisation.

1. Performance of the Economy

The policies do not appear to have any significant impact on sectoral or overall growth of the economy. This is evident from Table 13.1. The average annual growth rate of the economy in the post-liberalisation period is virtually equal to pre-liberalisation period, vide col, 4 (5.9% and 5.8% in the 2 periods). Similar picture can be gleaned as to the sectoral comparative performance. In fact, with regard to industrial sector, on which most of the reforms centred, the performance is not satisfactory in the post-liberalisation period. The observed average annual growth rate is 6.0% (col,2) which is 1.4% points less compared to pre-liberalisation period. With regard to agriculture, it is still worse (col.1).

2. Rate of Inflation :

The policies aimed at stabilisation internally and externally. Time series data do not give evidence to its positive impact. Table 13.2 contains 4 sets of inflation rates. All the 4 types of average annual rates of inflation inform that in the post-liberalisation period, prices rose faster by about 1.5% p.a. Needless to emphasise that inflation hits hard the poor and unemployed. We return to this shortly.

3. Public & Private Sectors' Shares in Employment :

The NIP with focus on more freedom and initiative to the private sector is supposed to boost employment through additional investment on the existing industries as well as new industries. Consequently, the relative shares alter in favour of the private sector in the total employment opportunities. To verify it, first we consider employment in the organised sector which is composed of the whole of public sector and corporate private sector. Table 13.3 presents sector-wise employment shares. The relative shares of public and private sectors are almost constant around 70% and 30% (cos 1 & 2 average figures). Only marginal yearly changes occurred in the relative shares. Constancy of shares does not necessarily mean that absolute employment remained constant. Growth in employment is examined below.

4. Growth of Employment & Unemployment :

What is the impact of the policies on employment in the organised sector? Table 13.4 give an account of growth in employment during 1983-97. There is mild slow down in the growth of employment at the aggregate (last row, 1.3% to 1.0%). However, when it is decomposed, private corporate sector exhibits enhancement in growth of employment from 0.6% in the pre-liberalisation period to 2.0% in the post-liberalisation period, (col 2). Further, when private sector is decomposed into large (employing 25 or more employees) and small (employing 10-20 employees), one interesting feature is observed. The observed growth in employment in the corporate private sector was contributed by both the small and large units. In the pre-liberalisation period, the growth rates of large and small were respectively 0.3% and 0.9%. The corresponding values in the post-liberalisation period are 2.0% and 1.7% per annum. Regarding public sector's contribution to growth in employment, there has been a perceptible decrease in the employment generated in the public sector. It may be concluded that the NIP has positive impact on employment in the private sector and negative impact in public sector.

Even though the organised sector, especially the private corporate sector, could second growth in employment, the rate of growth was not adequate to wipe out unemployment. Apart from backlog of unemployment, each year new labour force seek employment which is growing annually at about 2% which is less than over all growth rate of employment in India. Due to this, unemployment too has been growing. Col. 4 figures inform that unemployment growth slowed down from 6.9% to 2.2% in the 2 sub periods of analysis. These figures are based on the data supplied by Employment Exchanges. To be sure, the unemployment is of the persons who are on the live registers of Employment Exchanges.

5. Manufacturing Sub-Sector & Industry - Employment Growth :

Manufacturing is the major component of industrial sector. The latter includes electricity, gas, water supply, construction and mining, apart from manufacturing. While in the pre-liberalisation period both manufacturing and industry as a whole recorded negative growth in employment, in the post-liberalisation period growth picked up - 1.3%, 2.4% in the manufacturing and industry respectively, vide Table 13.5. The data thus suggest positive impact of NIP on employment.

6. Organised, Unorganised & SSI Sectors :

So far we concentrated on employment in the organised sector only. We now focus attention on industry only both organised and unorganised. Abridged data are presented in Table 13.6. In all the sub-periods shown in the Table, employment growth in the unorganised sector and SSI sector are much higher than in the organised sector. Further, compared to the periods up to 1988, in the recent sub-period of 1988-94, the average growth rate of employment is slower.

7. Impact on Poverty :

It should be remembered here that in India poverty is more severe and widespread than open unemployment. It is useful to know the impact of the policies on the poverty scenario. Table 13.7 gives proportion of people below the poverty line during select years of pre-and post-liberalisation periods. A close look at the Table informs that in the recent years poverty worsened. The proportions as well as absolute numbers of poor increased.

8. Impact on Structure of Industries :

One important impact of the NIP deserves special noting. In Unit 12, we examined changes in the relative weights of 4 major groups of industries during 1956-81. We now compare the weights of the industries with the base years of 1980-81 (pre-liberalisation) and 1993-94 (post-liberalisation). Necessary data are presented in Table 13.8.

Table 13.8
Relative Weights of Industries - Use Based Classification

Industry Group	Base Years	
	1980-81	1993-94
1. Basic Goods	39.4	35.5
2. Capital Goods	16.4	9.7
3. Intermediate Goods	20.5	26.4
4. Consumer Goods	23.7	28.4
a) Consumer Durables	(2.6)	(5.1)
b) Consumer Non Durables	(21.1)	(23.3)
Total Weights	100	100

Source : Economic Surveys.

A major disturbing impact of NIP is on capital goods industries and to some extent on basic goods industries. Their respective weights move down to 9.7% from 16.4% and to 35.5% from 39.4%. Remember here that industrialisation and self reliance crucially depends on capital and basic goods industries. The worsening impact of the decline is further probed shortly. Another impact is on nature of consumer goods industries. The share of durable consumer goods in the total consumer goods industries increased from 11% to 18% and those of non-durable declined from 89% to 82%. As most of the durable are luxuries, it indicates skewed income distribution in favour of the middle and rich class people.

A study conducted by Nambiar et al informs that trade liberalisation shrank India's manufacturing base both in terms of value-added and employment. Capital goods and intermediate goods suffered the most (their classification is three-fold viz. capital, intermediate and consumer goods). Import intensity of domestic manufacturing has increased. Manufacturing is shifting from high skilled and capital intensive to low skilled and labour intensive production. They conclude that trade is the root cause for crippling down Indian industry. Share of manufacturing in total non agricultural employment decreased to 24% by 1995-96 from 29% in 1970.

In brief, the impact of NIP is partially mixed. Apart from benevolent effects, the most disturbing impact is erosion of capital goods industry and its consequential negative impact on self reliance which independent India struggle to attain during 1950-90.

13.5 SUMMARY

This Unit and the preceding Unit 12 dealt with industrial policies. After explaining circumstances which rather forced India to liberalise the economy and effect the New Industrial Policy of 1991, we took up explanation of main features of the NIP. The policy is premised on the assumption that due to lack of competition and over regulation, Indian industry became inefficient and high cost. Therefore, the NIP aimed at removing restrictions and improving efficiency through internal and external competition. The main features of the policy are : reducing the role and scope of public sector, de-licensing the industries, dis-investment of public sector share holding and privatisation through other methods, automatic entry to foreigners in high priority sector, reforms in SSI sector and liberalising MRTP as well as FERA companies. After explaining the features, an assessment of the policy and its impact were examined. Impact

on overall and sectoral growth rates, on employment and unemployment growth, structure of industries and containing inflation were examined.

13.6 SELF - ASSESSMENT TEST

What are the salient features of the New Industrial Policy? What is its impact on employment, growth and structure of industries?

13.7 SUGGESTED READINGS

1. Government of India, Economic Surveys, Ministry of Finance, New Delhi (recent 3 years)
2. RBI, Reports on Currency and Finance, Mumbai (recent 3 years)
3. RGNAMBIAR, "Is Import Liberalisation Hurting Domestic Industries and Employment" Economic & Political Weekly, 34(7) 1999.

BRAOU

UNIT - 14 : MONETARY POLICY

Objectives

On reading this unit, you will be able to :

- understand meaning, relevance, scope and aims of RBI's monetary policy;
- know important instruments of monetary policy and how they operate ; and
- analyse recent changes in monetary policy in the context of liberalisation policies.

Structure

- 14.1 Introduction
- 14.2 Structure of Indian Banking
- 14.3 An Overview of Functions of RBI
- 14.4 Principal Instruments of Monetary-Credit Policy of the RBI
- 14.5 Recent Changes Aiming at Improving Efficiency, Competition and Effective Regulation
- 14.6 Summary
- 14.7 Self-Assessment Test
- 14.8 Suggested Readings

14.1 INTRODUCTION

Irrespective of degree of planning, in all the countries governments adopt macro economic policies. These policies enable the government to do or promote certain activities or discourage other activities. Macro economic policy has three arms viz., Fiscal, Monetary and/or Direct Measures. In Unit 15, you will be explained fiscal policy which is the policy of the government related to pattern of revenue raising and spending. Monetary policy, which is an arm of macro economic policy, is the policy of Central Bank. It is related to regulation of money supply and credit and hence monetary policy is inclusive of credit policy. Regulation means increase or decrease of money supply and quantity and quality of credit supplied to the economic agents in the country.

Today in each one of the 200 and odd countries of the globe, there is a Central Bank. The Central Bank of India is known as Reserve Bank of India (RBI). In the UK, it is called Bank of England, in Pakistan-State Bank of Pakistan, in Australia - Commonwealth Bank and so on. The RBI was established in 1934 by the RBI Act as a share holders bank and was nationalised in 1949 and is fully owned by the Government of India.

Multiple aims are pursued by the RBI in its monetary policy. The principal aim of monetary policy in India is to achieve stability (internal and external) and ensure adequate credit supply for productive activities. In the mixed economy setting of India, monetary policy has the responsibility of ensuring adequate credit supply to the public sector and productive credit needs of the private sector. Among the aims, price stability or controlling inflation is often given priority. The relevance of sound monetary policy needs no exaggeration. Without sound monetary policy, neither price stability is possible, growth can be accelerated nor efficient banking and financial system can be established.

Activity A

Explain the meaning of monetary policy and its aims in India.

14.2 STRUCTURE OF INDIAN BANKING

The RBI is apex of Indian banking and financial system. Non-Banking Financial Intermediaries (NBFIs) and banks constitute the substance of Indian financial system. The latter dominate over the former. Banks are also financial intermediaries and perform useful functions. They coordinate the surplus units with deficit spenders. They accept deposits and lend or invest the deposits. In the process of linking the depositors and loanees, the banking system as a whole acquire vast power to manufacture "money", credit or bank deposits. Banks affect both volume and pattern of investment. Here lies the crucial role of banks.

Banks in India are classified into Scheduled and Non-Scheduled categories. A Scheduled bank is one whose name is entered in the 2nd Schedule of the RBI Act of 1934. At present, there is only one Non-Scheduled Bank. All the other commercial banks are Scheduled Banks. In all, there are 344 Scheduled Banks of which 28 are non-commercial banks. All Scheduled Commercial Banks are 298 in 1997-98. The Scheduled Non-Commercial Banks (28 in number) are the State Cooperative Banks. Among the Scheduled Banks, SBI and its 7 subsidiaries are called SBI Group, 19 Nationalised Banks and 196 Regional Rural Banks (RRBs). Among all the banks operating in India, there are 41 Foreign Banks. Apart from the State Cooperative Banks and Commercial Banks, there are 1811 Primary Cooperative Urban Banks, of which 32 attained the status of Scheduled Banks. Among all the banks, SBI is the giant with over 6000 branches spread over India and quite a few foreign countries. It is some times known as Lender of Second Resort (while the RBI is the Lender of Last Resort). The Public Sector Banks (1+7+19+196) dominate the banking system of India. Their share in the aggregate deposits and loan of all the banks in India is about 85%. The aforesaid banks apart, a recent addition to the system is Local Area Banks (LABs). Out of 8 LABs for which the RBI gave permission, one already started functioning from December, 1999.

Activity - B

Sketch the outlines of Indian banking structure.

14.3 AN OVERVIEW OF FUNCTIONS OF RBI

As a prelude to understand monetary policy properly, let us note the functions of RBI. Like any other Central Bank, the RBI too performs general, regulatory and supervisory functions. These apart, it has the responsibility to assist in the development of the Indian economy.

The general functions performed by the RBI are :

1. Printing of currency or regulation of money;
2. Banker to governments;
3. Banker to all banks in the country;
4. Bank of Central Clearance, Transfer and Settlement;
5. Lender of Last Resort;
6. Controller of Forex Reserves of the country;
7. Controller of Credit Supply;

As this Unit is concerned with monetary policy, we concentrate on the 1st and the last functions.

14.4 PRINCIPAL INSTRUMENTS OF MONETARY-CREDIT POLICY OF THE RBI

1. Printing of Currency : As money or currency supply and credit supply are closely related, monetary policy includes credit policy. H Theory or High Powered Money Supply Theory neatly explains the links between money and credit. In brief, the theory says that Reserve Money (which is approximately equal to currency in circulation) is the main determinant of volume of credit. How is money supply regulated in India? As per the 1934 Act, RBI is the monopolist of currency printing. From 1956, currency is printed on the basis of Minimum Reserve System. It stipulates that the RBI shall always hold not less than Rs. 200 crores worth gold and foreign securities, of which gold shall be not less than Rs. 115 crores. The requirement of foreign securities can be dispensed with after securing permission from the government. Thus, practically the RBI can print any amount of money by holding just Rs. 115 crores worth gold. For e.g. in Feb. 2000, the currency in circulation in India crossed Rs. 1.9 lakh crores. In the RBI, there are 2 Departments - Issue & Banking. The Issue Department is guided by the principle of equality of assets and liabilities. For every Rupee printed, equal asset is to be possessed. While all denominations of currency notes are printed by the Issue Department of the RBI, all coins (including higher denominations of Rs. 2, 5 etc.) are minted by the Government of India. However, it is only the RBI (Banking Department) which can circulate coins and currency to public or withdraw from the public. The RBI prints currency as per the needs of growing economy and the Government. It is useful to note that a decision of the RBI to print one more unit of currency involves simultaneous decision to lend it to some one. Finally, as in the rest of the world, our currency is called inconvertible paper currency.

Activity C :

How is money printed in India? Is currency printing based on holding of gold reserves?

2. Credit Control :

Among the functions of RBI, one important function is regulation of volume, pattern (quality) and cost of credit. The need for control of credit arises from the fact that commercial banks in their lending operations are guided by profit motive. If they anticipate high profits, they over lend and if expectations are dark, they reduce credit supply. They are not interested very much in the general and economic welfare of the economy. Therefore, the RBI through various instruments regulates the volume, quality and cost of credit. It employs both quantitative and qualitative (Selective) credit tools to regulate credit. Bank Rate, Open Market Operations and Cash Reserve Ratio (CRR) are called quantitative tools. Credit rationing, consumer credit regulation, moral suasion, penalties and Statutory Liquidity Ratio (SLR) are the instruments of Selective controls. We discuss the quantitative credit controls and the tools of SLR at some length.

a) Bank Rate Policy :

Bank Rate (BR) is the official minimum lending or discounting rate of the RBI. It serves as barometer of interest rates in the economy. Through it, the RBI sends signals as to cost of funds. It is used to regulate interest rates of banks and (bill) discount rates as well as to arrest capital flight (outflow of funds from India). Based on the BR, banks fix their Prime Lending Rates (PLRs) and also deposit rates. PLR is the rate of interest charged by banks to first class customers. A rise in BR implies dear money policy and fall in it indicates cheap money policy. At present, the RBI is following cheap money policy by stabilising the BR at 8%.

b) Open Market Operations :

Open Market Operations (OMOs) are conducted to facilitate Government borrowings and stabilise security prices. Sale and purchase of securities/bonds by a Central Bank are called OMOs. In India, the RBI restricts OMOs to sale and purchase of first class securities only. These include gilt-edged securities of the Governments and Government guaranteed bonds. The main participants in the sale and purchase operations are commercial banks. When the RBI sells bonds, money flows into the RBI from banks and thereby the cash balances of the banks are reduced. When cash balances shrink, bank credit gets reduced by certain times. Opposite happens when the RBI purchases securities i.e. purchase operations release funds and banks are enabled to lend more. RBI is using the instrument mainly to facilitate government borrowings, repayments, stabilise bond prices and regulate short funds and thereby liquidity of the banks.

c) Cash Reserve Ratio :

The 1934 RBI Act stipulates that all banks are required to keep 3% to 15% of their demand and time liabilities with the RBI. By varying the Cash Reserve Ratio (CRR), quantity of credit rigen by the banks is regulated. Among all the credit control instruments of the RBI, CRR is the most powerful weapon to decrease/increase total volume of bank credit. However, it is a delicate tool and therefore Central Banks restrain themselves is using the instrument. By a stroke of pen or mere announcement by the RBI, overnight bank credit can be effectively

reduced or increased. For e.g. at present an increase of 1% in the CRR reduces cash balances of the Banks by about Rs. 7000 crores and thereby credit will be squeezed by certain times of the amount, say twice (Rs. 14000 crores). At present the CRR is 4.75%.

d) Statutory Liquidity Ratio :

According to the Banking Regulation Act of 1949, the RBI is authorised to fix Statutory Liquidity Ratio (SLR) of banks between 25% and 40%. By varying the ratio, the RBI attempts to regulate bank credit deployment between public and private sectors. Also, it influences quantity of bank credit. SLR is both Quantitative and Selective tool of credit control. SLR is the ratio of liquid balances to total liabilities. As nearly 90% of the liabilities of the banks are deposits, SLR is the ratio of liquid assets to total deposits. It may be defined as :

$$\text{SLR} = \frac{\text{Cash in Hand \& With Other Banks + Investments in Approved Securities}}{\text{Total Liabilities (Deposits)}}$$

A rise in the SLR shifts bank credit in favour of public sector and a fall in it enables banks to lend relatively larger amount to the private sector. Thus, SLR may be employed to redistribute bank credit between public and private sectors. At present SLR is 25%.

14.5 RECENT CHANGES AIMING AT IMPROVING EFFICIENCY, COMPETITION AND EFFECTIVE REGULATION

In the preceding Unit (13), you have studied various liberalisation policies pertaining to industry. Similar measures were initiated to liberalise banking system and promote efficiency. The present policies shift the emphasis from micro regulations to macro regulations. Interest rates, in stages, were deregulated. Banks are given freedom to announce their own rates of interest on deposits. They were given freedom to charge different interest rates to different customers and amounts. However, they are required to publicise their Prime Lending Rates. The system of PLR provides direction to the movement of interest rates in the credit market. The PLRs of banks move in tandem with changes in Bank Rate of the RBI. As the RBI reduced its Bank Rate, commercial banks suitably decreased their PLRs. Banks fix the PLRs at 3% to 5% higher than the Bank Rate. Recently the PLRs were slashed to 13% to 13.5% from 16% to 20%. However, although the PLRs were slashed, the weighted average interest rate did not decline much. Bank Rate, which was rather inactive earlier, has been activated both to deal with external shocks and internal situations. To improve profitability, both CRR and SLR were reduced by the RBI to 4.75% and 25% (which were respectively at the peak level of 15% and 38.5% before liberalisation). These measures pumped into the banking system additional liquidity and enabled the banks to improve profitability.

Competition was introduced into the banking system by relaxing entry and exit norms, and permitting public sector banks to raise additional capital from the market up to certain limits. New private sector banks including Local Area Banks and foreign banks were given permission. Prudential regulation and supervision are components of financial sector reforms. International prudential norms and practices with regard to capital adequacy, income recognition, provisioning and supervision. All the banks are required to achieve Capital to Risk Weighted Adequacy Ratio or in brief Capital Adequacy Ratio (CRAR or CAR) of 9%. With regard to Scheduled Primary Urban Cooperative Banks, initially they should attain 8% by 2001 and by 2003 10%. In the case of Non Scheduled Primary Cooperative Urban Banks the corresponding ratios are 6% and 8%. CRAR is also insisted upon for Non-Banking Financial Intermediaries (NBFIs). At present,

there are 40000 NBFIs, of which hardly 7000 are sound. Under the reforms, they were also brought under the regulation of the RBI. They were asked to register with the RBI and each of the NBFIs should have not owned funds worth Rs. 2 crores.

The level of Non-Performing Assets (NPAs) of the banks showed improvement due to transparency, provisioning and other prudential norms. Despite the recent improvement, they are still too high. To enable banks to raise their assets in line with real growth in the economy, they were allowed to have access with capital markets. Partial disinvestment of government share holding in the public sector banks is being implemented, facilitating private sector participation. To sum up, changes in monetary policy and financial sector reforms pursued since 1992 led to substantial deregulation of the banking sector, growth of various segments of the financial markets and increased importance of monetary policy in influencing credit flows in the economy.

14.6 SUMMARY

In this Unit, after mentioning that monetary policy is an arm of macroeconomic policy, formally we defined it and understood its relevance. As a prelude and to appreciate monetary policy, first the structure of Indian Banking System was explained. As monetary policy includes credit policy, first we listed the general functions of the RBI which is the apex of Indian banking and financial system. The principle of Minimum Reserve System followed in printing currency was explained. This was followed by an explanation of various monetary-credit policy instruments like Bank Rate, Open Market Operations, Cash Reserve Ratio and Statutory Liquidity Ratio. Recent changes in the context of liberalisation policies and reforms introduced since 1992 were also briefly explained.

14.7 SELF - ASSESSMENT TEST

What is monetary policy? How is credit regulated by the RBI?

14.8 SUGGESTED READINGS

1. S. B. Gupta, Monetary Economics, S Chand, New Delhi, 1982.
2. Bimal Jain, Finance & Development, RBI Bulletin, Jan 2000.
3. Economic Intelligence Cell, "Monetary & Credit Policy 1999-2000", PNB Monthly Review, April-June, 1999.

UNIT - 15: FISCAL POLICY

Objectives

After reading this Unit, you will be able to :

- Define Fiscal Policy;
- Know the Scope and Aims of Fiscal Policy;
- Appreciate Fiscal Reforms;
- Understand Tax System and Expenditure Pattern; and
- Analyse Structure of the Budgets

Structure

- 15.1 Introduction
- 15.2 Meaning, Scope & Aims of Fiscal Policy
- 15.3 Recent Fiscal Reforms
- 15.4 Tax Structure of Government of India
- 15.5 Pattern of Expenditure
- 15.6 Concepts of Deficits
- 15.7 Analysis of Budgets
- 15.8 Summary
- 15.9 Key Words
- 15.10 Self-Assessment Test
- 15.11 Further Readings

15.1 INTRODUCTION

You may recall that in the introduction to Block III, it was noted that there are three arms to Macro Economic Policies. World over, irrespective of economic system or level of development, today every country has a Macro Economic Policy. Through it, the government of the country, guided by national goals, encourages or discourages different socio-economic activities. One of the main components of Macro Economic Policies is Fiscal Policy.

15.2 MEANING, SCOPE & AIMS OF FISCAL POLICY

The word 'Fiscal' refers to government (or public revenue) and the calendar of the government for revenue and expenditure is called fiscal year or financial year (April-March). Fiscal Policy in brief means the policy of the government. To be more specific, it is the policy of the government related to pattern of revenue raising and revenue spending. In its broad sense, it includes public debt policy and budgetary policy. Aims of Fiscal Policy are the same as those of national objectives which are explicitly stated in the plan documents (Five Year Plans). Among others, its main aims are : assisting in acceleration of growth of the economy, encouraging exports, reducing inequalities among people and regions, and conferring social justice.

15.3 RECENT FISCAL REFORMS

As Fiscal Policy deals with public revenue, expenditure and debt, fiscal reforms are related to these three areas. Put differently, tax reforms, expenditure compression and debt reduction constitute the essence of fiscal reforms. After initiating structural adjustment programme under liberalisation milieu in 1991 July, Government of India constituted a Tax Reforms Committee, popularly known as Chellaiah Committee (it was chaired by Prof. Raja Chellaiah). The Committee submitted its Report in three parts - Interim Report in February 1992, Final Report Part I in August 1992 and Part II in January 1993. It made a detailed study on the structure of direct and indirect taxes and recommended tax reforms. They aimed at making the tax system more elastic and broad based, simplification of tax laws and regulations with a view to facilitate effective enforcement and compliance. The tax reforms covered two direct taxes (Corporation tax and Income Tax) and two indirect taxes (Excise and Customs Duties).

Tax Reforms :

Based on the recommendations of the Chellaiah Committee, Government of India implemented most of the suggested reforms in stages, beginning from 1992-93 Union Budget. Regarding Corporation Tax, it suggested that difference between the rates on domestic companies and foreign companies (incorporated abroad and operating in India) should not exceed 10% points and preferably the difference is to be around 7.5% points. Government accepted the recommendations. Corporation Tax on Domestic companies was reduced from 51.75% to 35% and on foreign companies to 45%. There is also surcharge. The budget for 2001-02 reduced the surcharge from 17% to 2%. Similarly Income Tax Rates were drastically reduced. Today there are 3 slabs viz. 10% (on incomes Rs. 0.5 - 0.6 lakh), 20% (on Rs. 0.6 - 1.5 lakh) and 30% (on Rs. 1.5 + lakh income earners) Effective from 2001 - 02, on income tax surcharge of 2% will be levied on incomes exceeding Rs. 0.6 lakh. Along with reduction in the income tax rates, tax base is widened. At present, persons falling under 1/6 formula (individuals having telephone, car, residential house (100 sqft), foreign travel, credit card and club membership) are required to submit self - assessment income tax returns. The system is extended to all the cities from the present indentified (134) cities.

Customs duties were drastically slashed from more than 300% to 35% (the 2000-01 budget reduced to 35% from the existing rate of 40%). The 2001-02 budget abolished 15% surcharge on custom duty. Union Excise Duties are simplified and reduced to 3 slabs. From 2000-01 a uniform CENVAT at 16% was levied (for details on VAT, MODVAT etc. see 15.4 below). It is proposed to transform all Union Excise Duties into CENVAT. Further, the state governments also agreed to convert Sales Tax into MODVAT, to be called State VAT from 2001-02. However, due to difficulties, in the meeting held with the Finance Minister, almost all the states accepted adoption of VAT from 2002 April. Government of India agreed to compensate loss if any incurred by a state from moving to VAT from Sales Tax. The 2001-02 budget kept constant CENVAT at 16% (and special Excise Duty at 16%). to improve profitability of banks, existing Interest Tax (2%) was abolished (effective from 2000-01).

Other measures to widen tax base and raise revenues include MAT (7.5%) on zero profit companies and Service Tax on brokers, transport operators, real estate dealers, telephone services etc. (5%).

Expenditure Compression :

With regard to expenditure, through zero based budget reduction in public expenditure is being attempted. It is recorded in the Budget Speech (2000-01 BE) that the principle of zero based budget was applied in the case of 8 departments. Fiscal deficit is sought to be reduced both through revenue rising and expenditure cuts. Excess staff estimated at 30% will be sized

over years. Subsidies are reduced on fertilisers, exports and food grains supplied through Public Distribution System.

Reforms in Fiscal and Budgetary Deficit :

With a view to manage fiscal deficit in the medium term, Fiscal Responsibility & Budget Management Bill was introduced in the Parliament in 2000. When this became Act, revenue deficit should be reduced to zero and that of Fiscal Deficit to 2% in five years. Another reform introduced in 1996 deserves mention. In the past, Government of India was availing unlimited facility from the RBI (Reserve Bank of India) through the system of issuance of Ad Hoc Treasury Bills (in brief ad hocs). The amount obtained against them is popularly known as deficit financing. With a view to disciplining government finances, two historical agreements were reached between the Central Government and RBI. Based on them, the Government phased out issuance of 4 decade old ad hocs with effect from April 1997.

When ad hocs were issued in the past, there was no compulsion on the government to roll back them. As they were issued year after year (without retiring the previous ad hocs), they become a permanent source of overdraft over the RBI. Based on the agreement, the government converted the outstanding ad hocs as on 31-3-1997 into Special Security without any specific maturity, but the government is required to pay interest at 4.6% on that amount. Fiscal pandits view it as an important reform to downsize aggregate deficit of the government. In the lieu of the assistance under ad hocs, Ways & Means are given by the RBI with certain upper limits for busy and slack seasons. Beyond the ceilings agreed upon, excess finances is provided at higher interest rate.

Devolution of Tax Revenue Reform :

Finally, mention may be made of devolution of tax revenue of the states. The Tenth Finance Commission (headed by KC Pant) recommended that 29% of all the union government tax revenue is to be transferred to the state government. Under the 29% formula, almost all the central taxes are included in the divisible pool (excluding stamp duty, excise duty on medicinal/toilet preparations, central sales tax, consignment tax and surcharge). The lumpsum share of 29% to the states is in lieu of the existing share in income tax, basic/special excise duties, additional excise duty in lieu of sales tax on tobacco, cotton and sugar, and grants in lieu of tax on railway passenger fares. The recommendation was accepted and to implement it, Constitution Amendment Act was passed (89th Amendment) in April 2000. This 29% devolution will be in force for 5 years (1996 April to 2000 March). The 11th Finance Commission headed by Prof. AM Khusro recommended devolution of 29.5% of the total net tax collected by the Union Government to the states. Out of 29.5%, 1.5% points devolution is towards additional Excise Duties in lieu of Sales Tax.

The percent share of vertical devolution (share in the central tax revenue to states) will be reviewed every 5 years by successive Finance Commissions. This is an important reform in the Centre - State financial devolution. For 2000-01, the devolution of states' share in central taxes is based on the provisional formula recommended by the 11th Finance Commission (its Chairman AM Khusro) in its Interim Report. Under this, states' share of the net proceeds of divisible income tax is 80% and in the Basic/Special Excise duties 52%.

15.4 TAX STRUCTURE OF GOVERNMENT OF INDIA

In the Constitution of India, Union and State Government's respective areas of administration and taxation are spelt out. One broad demarcation between the two types of governments is that on other than agriculture the union government can levy taxes and on agriculture related the States can levy. Broadly on 4 types of taxes, the union government

makes legislation. They are (a) Taxes levied and fully retained by the Union (e.g. Corporation Tax); (b) Taxes levied and collected by the union but are shared (e.g. Personal Income Tax); (c) Taxes levied and collected by the Union but fully assigned to the states; and (d) Union government only levies taxes but collected and enjoyed by the states. Example of the latter two categories are Central Sales Tax, Stamp Duty, Excise Duty on Medicinal and Toilet Preparations.

The union government levies both direct and indirect taxes, of which some are progressive, proportional, regressive, ad valorem and specific. Any tax whose initial (incidence) and final (impact) burdens are on the same person/institution, is a Direct Tax. If the two burdens are on different persons, it is Indirect Tax. Most of the personal taxes are Direct and most of the commodity taxes are Indirect. If the tax rate rises, as income/wealth/expenditure rises, it is a Progressive Tax (e.g. personal income tax). If the tax puts relatively more burden on the poor, it is Regressive Tax (e.g. taxes on essentials consumed by the common people). If the tax rate is constant, it is Proportional Tax (eg. Sales Tax). Tax based on value of the goods is called ad valorem. Most of the taxes are valorem in India. Specific Tax is based on weight, area/size (e.g. tax per 1000 units of cigarettes of certain length or Tax per square meter of cloth).

The important taxes levied by the union government are : Non-Agricultural Income Tax (in brief Income Tax), Corporation Tax (levied on the incomes of Registered Companies/corporations. Note : income of a company means its profits. Hence Corporation Tax is tax on profits), Union Excise Duties (Excise Duty is tax on production) on other than Liquors and Narcotics (on the latter states levy Excise Duties), Custom Duties (Import and Export taxes), Wealth Tax, Expenditure Tax (on expenditure incurred in Star Hotels), Dividend Tax (at 10% on the profits distributed and it is paid by the companies), Capital Gains Tax (Tax on the differential income of sale and purchase prices of assets (such as shares), MAT (Minimum Alternative Tax at 7.5% on the Zero Tax or Zero Profit Companies, Service Tax (at 5%) etc. The government also levies Surcharges which is a tax on tax amount (e.g. surcharge of 10% to 15% on Income Tax amount. It is interesting to note that while about 80% of the Income Tax revenue is distributed to the states, surcharge collections are retained in full by the Union).

Meaning of VAT and MODVAT :

There is MODVAT (Modified Value Added Tax) in lieu of Union Excise. From 2000-01, Modvat is renamed as CENVAT. Replacement of Excise/Sales Tax is regarded as tax reform. It was France which introduced VAT first time in 1954. Later the UK and USA introduced in 1972 and 1973 respectively. Value added means created or added value within a firm/production unit. It is equal to sales value less intermediate inputs and equals to the total of wages and surplus. If a tax is levied on the added value of the production unit, it is called VAT. Beginning from 1985-86, in India, Modvat (Modified VAT) was levied on selected industrial products. Gradually it is being extended to other industries and the 2000-01 budget envisaged to cover all the industries by abolishing existing Union Excises. Under Modvat, first the tax is levied on the sales value and rebate is later given for taxes paid in the earlier stages of production, subject to the production of vouchers. It is to be noted that the sum of the value added at each successive stage is equal to the final price of products and the sum of taxes paid at each successive stage will be the same as the tax which would be payable, if it were charged on the full value of the final product. It is the intension of the government to move to true VAT over the years under the name of CENVAT.

Among all the taxes, the highest net revenue is yielded by Customs Duties (and within Customs, close to 98% is from Import Duties), followed by Union Excises and Corporation Tax. Remember here that gross Union Excise Duties Collections are the highest but out of the total tax collected, states get close to one-half of the amount. Hence, in net terms, the highest income yielding tax is Customs Duty.

15.5 PATTERN OF EXPENDITURE

Expenditure/Payments of the government are classified under Revenue and Capital Expenditure. Expenditure incurred in discharging normal functions of the government is called Revenue Expenditure. Put differently, expenditure needed for providing the present level of services to the citizens is called Revenue Expenditure. In contrast, Capital Expenditure is on providing new facilities or creating additional assets which are of long term nature. Loans given to states are part of capital expenditure. As per 2001-02 BE (Budget Estimates), the ratio of Revenue to Capital Expenditures is 83:17.

Alternatively, expenditure is classified as Plan and Non-Plan Expenditure. As per 2001-01 BE, while Plan Expenditure is 27%, Non-Plan Expenditure is 73%. Among the Non-Plan Expenditures the three top expenditure items are Interest Payment (about Rs. 1.12 lakh crores), Defence (about Rs. 62,000 crores) and Subsidies (more than Rs. 30,000 crores). Within subsidies, the major ones are Fertilisers (about Rs. 10,000 crores), Food (about Rs. 14,000 crores) and Exports (more than Rs. 600 crores) subsidies. Some times expenditure is divided under two heads viz. Development and Non-Development. The two are in the ratio of around 45:55.

15.6 CONCEPTS OF DEFICITS

In fiscal analysis, 4 concepts of Deficits are often used. They are Revenue, Fiscal, Primary and Monetised Deficits. Revenue deficit is the excess of revenue expenditure over revenue receipts. As per 2001-02 BE, revenue deficit as proportion of GDP is 3.2%. Fiscal deficit is the excess of total expenditure of the government over its revenue. This is equal to all types of borrowings of the government during the year. It is estimated at 4.7%, Primary deficit is the excess of Fiscal Deficit over Interest Payments (Rs. 1.16 lakh crores less Rs. 1.12 lakh crores) and during 2001-02 the estimated primary deficit is around Rs. 4000 crores. As proportion to GDP, it works out to 0.2%. Based on the Chakravarty Committee (1985) recommendation the concept of Monetised Deficit was introduced. It catches the impact of fiscal operations on money supply. Net increase in the RBI credit to the government represents Monetised Deficit which is around 0.7%. While prior to 1980, critiques focussed attention on sizing Revenue and Budgetary Deficits (the latter represented deficit finance obtained through the issue of ad hocs), in the recent decades fiscal discipline is in terms of controlling Fiscal Deficit.

15.7 AN ANALYSIS OF UNION BUDGET 2001-02

As noted earlier, fiscal policy of the government is reflected in the budget and is implemented through various measures of revenue rising efforts and pattern of allocation of the resources. The budget for 2001-02 was presented to the Parliament on February 28, 2001 by the Finance Minister Yashwanth Sinha. This is his 4th budget. A budget is an annual statement of the estimated revenues, expenditure and their coordination. A budget is not merely a statement of the anticipated revenues and expenditures but something more. It serves as a tool to the MPs to have control over the government finances and to give direction to the economy. There are 3 sets of figures in the budgets viz. BE, RE and Actual or accounts. When presenting the Budget in February of 2001, the BE (Budget Estimates) are the estimated figures for the next year (say, 2001-02), RE (Revised Estimates) are for the current year (say, 2000-01) and Actuals pertain to the previous year (say, 1999-2000). Each Budget is classified under Revenue and Capital Accounts. In both the accounts, receipts and payments are shown. Revenue receipts are broadly of 2 types- Tax and Non-Tax revenue (e.g. of the latter are fees, penalties, dividend received by the government etc.). While Tax Revenue constitutes 70%, non-tax revenue is 30%. In the tax revenue, at present the shares of Direct and Indirect Taxes are 38% and 62%

respectively. It is happy to record that in the recent 20 years, the proportion of direct tax revenue has been rising. In the total receipts of the government (about Rs. 2.8 lakh crores), Revenue Receipts account for 62% and Capital Receipts (mostly borrowings) 38%. We already noted that in the total expenditure, bulk is on Revenue Expenditure at 83%.

Observations on the 2001-02 Budget :

This budget, like the budgets of the previous years, is an incremental exercise and does not contain hard decisions, as claimed earlier by the Finance Minister, to set right the economy. It is true that the budget included certain measures to prune the Fiscal Deficit which stood at 5.1% in 2000-01 to 4.7% in 2001-02. Union Excise Duties are further rationalised and from 2001-02 a single uniform rate of 16% CENVAT will be levied (along with 16% Special Excise Duty). To reduce tax burden, surcharge on income tax is slashed to 2% (from 17%) and this 2% will be levied only when taxable income exceeds Rs. 0.6 lakh. Dividend tax, which was enhanced from 10% to 20% in the BE 2000-01, is reduced to 10% in the current budget (2001-02). To discourage import of second hand cars, the budget proposes to levy 180%. The average import duty is around 35% which is comparable with global countries. On most of the I.T. (Information Technology) products, import duties were reduced to encourage spread of modern communication knowledge. Attempt was made to reduce the burden of fertiliser and food subsidies by raising the prices of fertilisers and issue price of food grains distributed through Public Distribution System. The budget announced a few social welfare schemes and touched agricultural sector. The budget strengthens agricultural bank finance, insurance of farmers and enhance micro credit facilities. It aims at linking one more lakh Self Help Groups (SHGs) with the help of NABARD and SIDBI for credit delivery to the members of SHGs. Not only every farmer will be issued Kisan Card, they will be insured at cost of banks which issued the cards. With effect from 13-01-2001, 82 lakh old age pensioners have been provided 10 kg rice or wheat free of cost. Shiksha Shayog Yojana was announced under which BPL (Below Poverty Line) families children will get education allowance of Rs. 100 p.m. to study 9th to 12th classes. Also Khetihhar Mazdur Bima Yojana was announced. Under this agricultural labourers will be provided a pension of Rs. 100 p.m. after attaining 60 years. It will be implemented by the LIC. To facilitate foreign investment by FIIs (Foreign Institutional Investors), the ceiling of 40% was raised to 49%. The Finance Minister in his budget speech commented that liberalisation policies implemented during the decades of the 1990s fairly succeeded in ensuring **free entry**. Free entry is one of the two important elements of competitive conditions. The other element is **free exit**. Under the second generation or second phase of reforms, free exit policy is announced. Free exit means that freedom to close the business/industry and to retrench/lay off workers. It is informed that till now industries with 100 + employment are required to obtain permission from government for lay off, lockup, retrenchment and closure. Now the employment limit is 1000 +. Industries employing less than this number need not approach the government for retrenchment or lay off. However, the budget provided certain safeguards. The retrenched labour is given separation compensation equal to 45 day of pay for every completed year of service. Also Ashray Bima Yojana applies to them. Compensation upto 30% of last pay drawn will be paid by the industry for one year. The budget also indicated that contract labour will be soon legitimised. The 2001-02 budget announced that as against the present limit of 1000 workers, it is proposed to recruit civilians to the extent of 1% of total staff against annual retirement of 3%. This measure aims to compressing the work force which is in excess of needs. The budget also announced raising of rent on government buildings by 15% to 50% and all existing schemes will be subject to Zero Based Budgeting. Although the professed goal of the budget is "to impart Indian Economy sustained equitable and job creating growth path of 7% to 8% which could banish poverty and unemployment", it is doubtful that the goal would be achieved. The allocations and policies are not consistent with goal. It appears that the budget was dominated more by market rather than by the compassionate state.

15.8 SUMMARY

In this unit, attempt was made to explain essentials of fiscal policy, fiscal reforms and the Budget of 2001-2002. After defining fiscal policy, explaining its scope and aims, various fiscal reforms introduced from the 1990s were discussed. It was noted that the reforms concentrated on fiscal discipline, abolition of the system of ad hocs, tax reforms which included tax rationalisation, administration, widening tax base and reduction of a number of taxes including import duties. Based on the recommendation of the 10th Finance commission, vertical distribution share at 29% has been legalised through an amendment to the Constitution. The government also accepted 29.5% devolution of total tax revenue recommended by the 11th Finance Commission. A recent reform is the decision to control revenue and fiscal deficits through an enactment called Fiscal Responsibility and Budget Management Bill. Different types of taxes and main revenue yielding taxes were explained. Alternative classification of expenditure and main expenditure items were noted. After defining 4 types of deficits, a few observations were made on the 2001-02 budget including new schemes and exit policy.

15.9 KEY WORDS

1. **Budget** : an Annual statement of estimated revenue and expenditure, and their coordination. It reflects fiscal policy and is expected to give direction to the economy.
 2. **CENVAT** : Central VAT is the New name of Modvat (Modified Value Added Tax). Over years, CENVAT is expected to be transformed into true VAT. Under VAT, tax is levied at every stage of production/sale on the created or added value of that particular company. Under Modvat, first the tax is levied on the total sales value, and later rebate is given for the taxes paid by it in procuring inputs, provided tax vouchers are produced.
 3. **Fiscal Deficit** : Excess of total government expenditure over its income. It is equal to all types of borrowing of the government during a year.
 4. **Fiscal Policy** : Policy of the government related to pattern of revenue raising and spending.
 5. **MAT** : Minimum Alternative Tax is levied on zero profit companies which actually earn profits but they show book profits as zero after deducting legally permitted allowances.
 6. **Monetised Deficit** : Net increase in RBI's credit to government during a period. It catches impact of fiscal operations on money supply.
 7. **Primary Deficit** : Fiscal deficit less interest payments.
 8. **Revenue Deficit** : It is the excess revenue expenditure of the government over revenue receipts. Put differently, excess of normal expenditure over normal income of the government.
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15.10 SELF - ASSESSMENT TEST

1. Define the term fiscal policy and distinguish it from monetary policy.
2. Explain the concepts of fiscal deficit and revenue deficit.
3. What are VAT, MODVAT, CENVAT and State VAT?
4. What are the direct and indirect taxes of the union government and which taxes are more revenue yielding?

5. Explain briefly fiscal reforms introduced by the Government of India under liberalisation environment.
6. Analyse the recent year's budget.

15.11 FURTHER READINGS :

B. P. Tyagi : Public Finance

RBI : Currency and Finance, Mumbai 1999-2001.

Recent Issues of Economic & Political Weekly.

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UNIT - 16 : FINANCIAL SECTOR REFORMS

Objectives

After studying this unit, you should be able to :

- Understand the need for reforms in financial sector in India;
- Explain the main recommendations of the Narasimham Committee;
- Specify the action taken by the Government and the RBI for reforming the financial sector in India; and
- Assess the impact of reforms on Indian Economy;

Structure

- 16.1 Introduction
- 16.2 Need for Reforms in Financial Sector
- 16.3 Narasimham Committee on Financial Reforms
- 16.4 Major Recommendations of Narasimham Committee
- 16.5 Financial Sector Reforms
- 16.6 Towards Sound Financial Sector
- 16.7 Summary
- 16.8 Self - Assessment Test
- 16.9 Further Readings

16.1 INTRODUCTION

A country's financial system is a facilitative set-up like infrastructure. It caters to the needs of both the lenders and the borrowers. It is comprised of financial institutions like commercial banks, development banks, co-operative credit societies, insurance agencies etc. It also includes financial markets viz., money market and capital market. A sound financial system contributes enormously to the expansion and diversification of an economy and also to its growth.

The essence of a financial system lies in its role as an intermediary between those who have surpluses to lend and those who want to borrow. According to Prof. C. Rangarajan, the former Governor of the Reserve Bank of India, the central economic function of the financial sector is financial intermediation, that is mobilisation of financial resources and the allocation of these financial resources. Further, efficient financial intermediation also involves minimising the transaction cost of transferring funds from original savers to final investors.

16.2 NEED FOR REFORMS IN FINANCIAL SECTOR

The Indian Financial Sector today comprises an impressive net work of Banks, Development Financial Institutions (DFIs), Insurance, Finance, Leasing, Venture Capital and Mutual Fund Companies, and a wide range of financial instruments. There has been a considerable widening and deepening of the Indian Financial System, particularly in the last two decades. Despite the overall progress made by the financial system in India, its operational system has been unsatisfactory up to 1991. In July, 1991 the Central Government announced its New

Economic Policy (NEP). Liberalisation, deregulation, delicensing, reforming and restructuring of the economy through NEP made the Government to bring reforms in financial sector immediately.

Let us now discuss the need for undertaking reforms in financial sector with particular reference to banks and developmental financial institutions. Financial sector reforms were initiated as part of the overall structural reforms aimed at improving the productivity and efficiency of the economy. The financial sector reforms recognise the fact that the Indian Banking System had, over the years, grown and that the geographical and functional coverage of the banking system have been truly impressive. However, questions have been raised from time to time on the viability of the banking institutions. Concerns have also been expressed about the deterioration in the quality of services provided by banks. It is with a view to finding solutions to these problems that financial sector reforms were initiated. The broad objective of the reform has thus been to create a banking system that is both viable and efficient.

Commercial Banking in India :

Nationalisation of 14 commercial banks on 19th July, 1969 was a radical measure in the history of Indian banking. Several changes took place in the sphere of banking sector after nationalisation. These changes are quite apparent in branch expansion, deposit mobilisation, credit deployment etc.

Despite the overall progress made by the banking system in India, its operational efficiency has been unsatisfactory - characterised by low profitability, high and growing non-performing assets and relatively low capital base. On the eve of the reforms, the net profits of public sector banks (excluding RRBs) after provisions and contingencies were not more than 0.18 per cent of working funds in 1990-91. The spread between interest earned and paid as a proportion of working funds was 2.95 per cent. The proportion of non-interest expenditure to working funds in the same year was 2.65 per cent. With the decline in the quality of loan assets, the need for provisioning had become more urgent. Several banks were in fact not in a position to make adequate provisions for doubtful debts. The capital base i.e., the ratio of paid-up capital and reserves to deposits, of public sector banks at slightly over 2.85 per cent in 1990-91 was much lower by international standards and in fact, has gone down over time.

The major factors responsible for these are : (a) directed investments; and (b) directed credit programmes. In both these cases, rates of interest that were available to banks were less than the market related rates or what they could have secured from alternate deployment of funds. There has been a deterioration in the quality of the loan portfolio which in turn has come in the way of banks' income generation and enhancement of their capital funds. The accounting and disclosure practices also do not always reflect the true state of affairs of banks and financial institutions. The erosion of profitability of banks has also emanated from the side of expenditure as a result of fast and massive expansion of branches, many of which are unremunerative especially in the rural areas, a considerable degree of overmanning particularly in the urban and metropolitan centres and inadequate progress in updating work technology. Both management weaknesses and trade union pressures have contributed to this. There have also been weaknesses in the internal organisational structure of the banks, lack of sufficient delegation of authority and inadequate internal controls and deterioration in what is termed 'housekeeping' such as balancing of books and reconciliation of inter-branch and inter-bank entries.

The most serious damage to the banking system and the one which contributed most to the decline of portfolio quality has been political and administrative interference in credit decision-making. Populism and political and administrative influence bordering on interference should have no place in the lexicon of banking and finance, but unfortunately, over the years, competitive populism has affected banking and credit operations. As a result of the political and administrative

interferences the public sector banks in India have suffered so badly : lower income, inadequate provisioning for bad debt, locking of credit from more productive uses and erosion of profitability. The deterioration in the financial health of the system has reached a point where unless remedial measures are taken soon, it could further erode the real value of and return on the savings entrusted to them and even have an adverse impact on depositor and investor confidence.

Before the onset of financial sector reforms in 1991, every conceivable banking activity of Indian banks was regulated by RBI/Government of India e.g., rates of interests on deposits/advances, credit dispensation system, branch expansion policy and entry of private/foreign banks etc. There was no transparency of balance sheet of banks and banks could increase their liabilities in highly disproportionate ratio to their capital funds. There was no uniform system of identifying bad advances and providing against these. All these were affecting the intrinsic strength of public sector banks. As there was no stress on profitability, these banks never got motivated to increase their efficiency/profitability.

Development Financial Institutions (DFIs) :

Alongside the quantitative expansion and functional diversification of the banking system, the last few decades have witnessed a significant expansion of the activities of term lending or development financial institutions (DFIs). With commercial banks confining themselves to their traditional provisioning of working capital requirements of trade and industry, the role of specialised financial institutions was seen as meeting the requirements of medium and long-term finance for industry. The network of financial institutions comprising the three all-India development banks (IDBI, ICICI, and IFCI) and 18 State Financial Corporations and 26 State Industrial Corporations have thus brought about a countrywide coverage of term-lending facilities.

The DFIs have also been suffering from a degree of portfolio contamination. This is more pronounced in the case of the State Financial Corporations (SFCs). Being smaller institutions the internal organisational problems of the DFIs have been less acute than those of the banks. However, both banks and the DFIs have suffered from excessive administrative and political interference in individual credit decision making and internal management. The deterioration in the financial health of the system has reached a point where unless remedial measures are taken soon, it could further erode the real value of and return on the savings entrusted to them and even have an adverse impact on depositor and investor confidence.

Activity - A

Assuming yourself as an officer of a Nationalised Bank, list out the strengths and weaknesses of banking sector in India before the implementation of the reforms by the Government and RBI on the recommendations of Narasimham Committee.

16.3 NARASIMHAM COMMITTEE ON FINANCIAL REFORMS

The Government of India had set up a High Level Committee in August, 1991 with Mr. M. Narasimham, the former Governor of the Reserve Bank of India as its Chairman to examine all aspects relating to the structure, organisation, functions and procedures of the financial system in India.

16.4 MAJOR RECOMMENDATIONS OF NARASIMHAM COMMITTEE

Narasimham Committee was primarily interested in improving the financial health of public sector banks and development financial institutions, so as to make them viable and efficient and meet fully the emerging needs of the real economy. The basic assumption and approach of the Committee is that greater market orientation would strengthen the financial system and thus improve its efficiency. In this connection the Committee stated **"The solvency, health and efficiency of the institutions should be central to effective financial reform"**. The major recommendations of the Narasimham Committee centre round the banking system, the development finance institutions, the money and capital markets.

Recommendations Relating to Banking System :

The Narasimham Committee's recommendations are based on the fundamental assumption that the resources of the banks come from the general public and held by the banks in trust and that they have to be deployed for maximum benefit of their owners, viz., the depositors. This assumption automatically implies that even the Government has no business to endanger the solvency, health and efficiency of the nationalised banks under the pretext of resources for economic planning, social banking, poverty eradication, etc.

The Narasimham Committee recommendations aim at :

- i) ensuring a degree of operational flexibility;
- ii) internal autonomy for the public sector banks in their decision making process; and
- iii) greater degree of professionalism in banking operations.

1. Directed Investments and Credit :

The Committee recommended for reducing Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) progressively over the years. As regards directed lending, the Committee proposed for the re-definition of the priority sector to include only the small and marginal farmers, the tiny sector of the industry, small business and transport operators, village and cottage industries, rural artisan and other weaker sections. The Committee recommended to fix the aggregate credit of 10 per cent to the redefined priority sector.

2. Deregulation of Interest Rates :

Narasimham Committee felt that the present structure of administered interest rates are highly complex and rigid and hence proposed for the deregulation of interest rates so as to reflect emerging market conditions.

3. Prudential Norms and Regulations :

Prudential norms and regulations mean the norms and regulations relating to income recognition, provisioning for bad and doubtful debts and capital adequacy. With regard to income recognition the Committee recommended that in respect of banks and financial institutions which follow the accrual system of accounting, no income should be recognised in the accounts in respect of non-performing assets. An asset would be considered non-performing if interest on such asset remains due for a period exceeding 180 days at the balance sheet date.

For the purpose of provisioning, the Committee recommended that using the health code classification which is already in vogue in banks and financial institutions, the assets should be classified into four categories namely, Standard, Sub-standard, Doubtful and Loss Assets. In regard to Sub-Standard Assets, a general provision should be created equal to 10 per cent of the

total outstanding under this category. In respect of doubtful debts, provision should be created to the extent of 100 per cent of the security shortfall. In respect of the secured portion of some doubtful debts, further provision should be created, ranging from 20 per cent to 50 per cent, depending on the period for which such assets remain in the doubtful category. Loss Assets should either be fully written off or provision be created to the extent of 100 per cent.

The Committee stated that the balance sheets of banks and financial institutions should be made transparent and full disclosures made in the balance sheets as recommended by the International Accounting Standards Committee.

While coming to the capital adequacy of the banking system the Committee suggested that the banks and financial institutions should achieve a minimum 4 per cent capital adequacy ratio in relation to risk weighted asset by March 1993, of which Tier 1 capital should be not less than 2 per cent. The Bank of International Settlements, (BIS) standards of 8 per cent should be achieved over the period of the following 3 years, that is, by March 1996. For those banks with an international presence it would be necessary to reach these figures even earlier. The Committee opined that in respect of those banks whose operations have been profitable and which enjoy a good reputation in the markets, they could straight away approach the capital market for enhancement of their capital.

4. Recovery of Loans :

Banks, at present, are experiencing considerable difficulties in recoveries of loans and enforcement of security charged to them. The delays that characterise our legal system have resulted in the blocking of a significant portion of the funds of banks and DFIs in unproductive assets, the value of which deteriorate with passage of time. The Committee, therefore, considered that there is urgent need to work out a suitable mechanism through which the dues to the credit institutions could be realised without delay and strongly recommended that Special Tribunals on the pattern recommended by the Tiwari Committee on the subject be set up to speed up the process of recovery.

5. Other Suggestions :

The other major recommendations of the Committee include the following:

1. The Committee recommended for the substantial reduction in the number of public sector banks through mergers and acquisitions. The Committee favoured 3 to 4 large banks with international in-character; 8 to 10 national banks with net work throughout the country; local banks with regional operation and rural banks including RRBs for rural areas.
2. The Committee while endorsing the views of Rangarajan Committee on Computerisation recommended for greater use of computerisation systems in banks.
3. The Committee recommended for ending the present dual control of banking system by RBI and Ministry of Finance and recommended for RBI's sole supervision.
4. The Committee also recommended for a radical change in work technology and culture for each bank. It also favoured for the appointment of chief executive of a bank not on principle consideration but on professionalism and integrity to be selected by an independent panel of experts.

Reforms Relating to DFIs

The following are the major recommendations of the Narasimham Committee relating to Development Financial Institutions (DFIs).

- i) The ownership pattern of DFIs should be broad-based, like that of ICICI.

- ii) The Government should work out an action plan to be implemented in the next three years which would usher in a measure of autonomy of the DFIs in matters of internal administration.
- iii) The appointment of chief executives of DFIs should be from amongst men of proven professional competence and should be selected on the recommendations of panel of eminent persons.
- iv) The Boards of DFIs should include representatives from the industrial sector.
- v) The DFIs should raise their funds from the capital market at market-related rates. They should also mobilise the savings of the household sector through some schemes which do not conflict with the commercial banks.
- vi) As regards loan sanctions, each DFI should have the sole responsibility in loan sanctions. It should be guided by professional appraisal of the technical and economic aspects of the project evaluation of the promoters, competence and integrity. The DFIs should supervise their own loan implementation.
- vii) In the matter of corporate take-overs, DFIs should lend support to existing managements with proven record beneficial to all concerned, except in those cases where the new management can do better. In all cases, the DFIs should exercise their individual professional judgement free of any extraneous pressures.

Capital Market Reforms :

The Committee favoured substantial and speedy liberalisation of the capital market. Prior approval by any agency - either Government or SEBI - for any issue in the market should be dispensed with. The issuer should be free to decide on the nature of the instrument, its terms and its pricing. The SEBI should formulate a set of prudential guidelines designed to protect the interests of investor. In the Committee's view, SEBI should not become a controlling authority substituting the Controller of Capital Issues (CCI), but should function more as a market regulator to see that the market is operated on the basis of well laid down principles and conventions. The capital market should be gradually opened up to foreign portfolio investment and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments. Towards facilitating securitisation of debt, which could increase the flow of instruments, appropriate amendments will need to be carried out in the Stamp Act.

The Committee recommended that the supervision of merchant banks, mutual funds, leasing companies, venture capital companies etc., which form an integral part of the financial system should come within the purview of the new agency to be set up for this purpose under the aegis of the RBI. The control of these institutions should be principally confined to off-site supervision with the on-site supervision being resorted to cases which call for active intervention. The SEBI which is charged with the responsibility of ensuring orderly functioning of the market should have jurisdiction over these institutions to the extent their activities impinge on market operations. In regard to mutual funds there is a good case for enacting new legislation on the lines obtaining in several countries with a view to providing an appropriate legal framework for their constitution and functioning. The present guidelines with regard to venture capital companies are unduly restrictive, and affecting the growth of this business and need to be reviewed and amended.

Second Phase of Recommendations - Narasimham Committee - II

Although substantial progress has already been made as a result of implementation of several recommendations made by the first Narasimham Committee, it becomes necessary now to go for further reforms in the banking sector. The second report of Narasimham Committee

(1998) provided the basis for further strengthening of the banking system for doing so in this direction.

The major recommendations of the Narasimham Committee includes measures to strengthen the banking system, systems and methods in banks and structural issues, which are enumerated briefly below :

Measures to Strengthen the Banking System :

1. Enhancement of Capital Adequacy requirements of Banks to 10 per cent in phased manner.
2. Government guaranteed advances which otherwise would have been classified as Non-Performing Assets (NPAs) should either be treated as NPA or shown separately in the balance sheet as a move towards greater transparency in banks' operations.
3. Average level of net NPAs for all banks should be reduced to below 5 per cent by the year 2000 and 3 per cent by 2002. For banks with international presence, the objective should be to reduce net NPAs to 3 per cent by the year 2000 and nil per cent by 2002.
4. Financial restructuring with the objective of having off the NPA portfolio from the books of the bank through Securitisation or Asset Reconstruction Company must go hand in hand with operational re-structuring.
5. Freedom to banks in deciding lending rates and also beneficiaries under government sponsored schemes within the priority sector advances.
6. To bring in alignment with the international practices, 90 days norm in regard to income recognition to be introduced in phased manner and general provision of 1 per cent for standard assets.
7. Adoption of international disclosure practices and consolidated balance sheet to be made mandatory to reveal the strength of the group.

Systems and Methods in Banks :

1. Reconstitution of Management Committee with only full time functionaries on the pattern of Central Office Credit Committee in SBI.
2. Whole time directors on the board of banks.
3. RBI should allow banks to select their statutory auditors.
4. Freedom to banks to decided their remuneration package including that of their Chief Executives.
5. Separate vigilance manual which captures the special features of banking should be prepared for exercising effective supervision over-banks.

Structural Issues :

1. Mergers between banks and between banks and DFIs/NBFCs need to be based on synergies and locational and business specific complementarities of the concerned institutions and must make sound commercial sense.
2. Constitution of Restructuring Commission for Weak Banks.
3. Minimum Share holding by government/RBI in the equity of nationalised banks and SBI should be brought down to 33 per cent. Appointment of Chairman and Managing Director should be left to individual Boards and Boards themselves should be elected by shareholders.

4. Minimum net worth for NBFCs and Urban co-op, banks should be raised in phased number.
5. Forex market, Money market and the Securities market should be allowed to integrate and the forward premia should reflect the interest rate differentials.
6. Banks should be required to publish half yearly disclosure requirements in two parts. The first should be general disclosure, providing a summary of performance over 3 years and second disclosure, which would be a brief summary aimed at creditors, investors and rating agencies to get a true picture.
7. The Board for Financial Regulation and Supervision (BFRS) should be given statutory powers and be reconstituted with professionals.
8. Legal framework to be amended to keep pace with changing commercial practices and with the financial sector reforms.

Varma Committee :

The Reserve Bank of India constituted a working group under Mr. M.S. Verma, its honorary adviser and former chairman of State Bank of India, with the following terms of reference :

- To establish the criteria for identifying the weak banks.
- To study and examine the problems of such weak banks.
- To examine them case by case and identify the potentially revivable among them and
- To suggest a strategic plan of financial, organisational and operational restructuring of such banks.

Criteria to Spot Weak banks :

The working group identified seven parameters with which to evaluate banks. These are :

- i. Capital Adequacy Ratio;
- ii. Coverage Ratio;
- iii. Return on Assets;
- iv. Net Interest Margin;
- v. Ratio of Operating Profit to Average Working Funds;
- vi. Ratio of Cost to Inome; and
- vii. Ratio of Staff Costs to Net Interest Income plus all Other Incomes.

Banks that did not achieve the required level under these parameters were considered weak.

The Committee while indentifying three weak public sector banks. (viz., Indian Bank, UCO Bank and United Bank of India) recommended many measures including setting up of an Asset Reconstruction Fund, cutting the work force 25 per cent and strategic alliance with other banks (Including non-banking financial institutions (NBFCs).

Activity - B

Explain the major recommendations of Narasimham Committee relating to banking sector.

Activity - C

“The suggestions made by the Narasimham Committee relating to DFIs, if implemented, will bring about far reaching changes in the working of these institutions.” If so, state the reasons.

16.5 FINANCIAL SECTOR REFORMS

The Government of India, while accepting the report of Narasimham Committee took the following measures to streamline the financial sector in India. The RBI also started issuing guidelines to the bank and financial institutions basing on the recommendations of the Narasimham Committee. The Government of India and RBI took the following measures for reforming the financial sector.

1. Changes in SLR and CRR :

Statutory Liquidity Ratio (SLR) on incremental net domestic demand and time liabilities (NDTL) has been reduced from 38.5 per cent in 1991-92 to 15 per cent. SLR on outstanding domestic NDTL has been reduced from 38.5 per cent in 1991-92 to 31.50 per cent. It is expected to be brought down to 29.5 per cent by March 1995.

Incremental Cash Reserve Ratio (CRR) of 10 per cent has been removed and one-third of the impounded cash balances under incremental CRR have been released, implying a reduction in CRR by 0.6 per cent. In November, 1995 the RBI reduced CRR from 15% to 14% in order to control the variations in the money market. CRR was further reduced from 10.5 per cent to 9 per cent with effect from November 20, 1999. At present, the CRR is 4.75%.

2. Deregulation of Interest Rates :

The RBI, in September, 1995, allowed scheduled commercial banks to fix interest rates on deposits and loans on their own. The purpose of the deregulation of interest rates of banks is to stimulate healthy competition among the banks and encourage their operational efficiency. The Reserve Bank of India issued guidelines for interest rate swaps and forward rate agreements.

3. Prudential Norms :

Prudential norms have been laid down by RBI as part of the reformatory process. The purpose of prudential system of recognition of income, classification of assets and provisioning of bad debts is to ensure that the books of the commercial banks reflect their financial position more accurately and in accordance with internationally accepted accounting practices. There will help in more effective supervision of banks. Now, prudential norms require banks to make 100 per cent provision for all loss assets or non-performing assets (NPAs).

4. Capital Adequacy Norms :

The RBI in April, 1992 fixed capital adequacy norms for banks. The banks have to comply with the norms over a three year period. Banks were expected to reach 4 per cent of capital to risk assets ratio (CRAR) by March, 1993. This should be raised to 8 per cent by March, 1996 for by all scheduled commercial banks. Foreign banks operating in India and Indian banks with international presence were, however, required to attain 8 per cent by March, 1993 and 1994 respectively.

A new capital framework has been introduced for Indian scheduled commercial banks based on the Basu Committee recommendations presenting two tiers of capital for the banks.

The Government of India has amended the Banking Companies Act to enable the nationalised banks to access the market for capital funds through public issues, subject to the provision that the holding of the Central Government will not fall below 51 per cent of the paid-up capital.

5. Freedom of Operation :

Scheduled commercial banks have now been given freedom to open new branches and upgrade extension counters, after fulfilling capital adequacy norms and prudential accounting standards. They are also permitted to close non-viable branches other than in rural areas. Bank lending norms have been liberalised and banks have been given freedom to decide levels of holding of individual items of inventories and receivables.

6. Permission for New Banks :

Government of India and RBI have accepted 12 proposals to set up new private sector banks and six banks have already started functioning. These banks have been allowed to raise capital contribution from foreign institutional investors upto 20 per cent and Non-Resident Indians up to 40 per cent.

7. Supervision over Commercial Banks :

A Board of Financial Supervision has been set up with an Advisory Council to strengthen the supervisory system of banks and financial institutions. A separate Department of Supervision was also established in RBI in December 1993 for assisting the Board.

8. Recovery of Debts :

"Recovery of Debts due to Banks and Financial Institutions Act, 1993" was passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan arrears. Five tribunals started functioning at Calcutta, Delhi, Jaipur Ahmadabad and Bangalore and an Appellate Tribunal has been set up at Mumbai.

9. Other Measures :

The Government of India took the following other measures also to reform and strengthen the financial sector in India.

- a) Banking Regulation act, 1949 was amended to enable a banking company to have a non-executive Chairman and upto three Directors from among the Directors promoting institutions, and to raise the ceiling for the exercise of voting rights for a shareholder upto 10 per cent, and to raise the penalties for contravention of the Act.
- b) Agreement was reached with Unions in October 1993 and it paved way for faster computerisation in banks.
- c) Bank lending norms have been liberalised and banks were given freedom to decide levels of holding of individual items of inventories and receivables.
- d) Scope of mandatory consortium arrangement was narrowed to 76 large borrowal accounts in place of 934 accounts.
- e) Guidelines were issued to banks to ensure qualitative improvement in banks' customer service as a follow-up on the recommendations of the committee on customer service in banks.
- f) With effect from the year ending March 31, 2000, banks advised to classify a minimum of 75% of their securities as current investments.
- g) In line with the recommendation Narasimham Committee (II) to provide RBI support to market through liquidity adjustment facility involving periodic/daily resetting of Repo and Reverse Repo Rates, RBI introduced Interim Liquidity Adjustment Facility (ILAF) with effect from April, 21, 1999 in place of the General Refinance facility.

10. Reforms Relating to DFIs :

The DFIs have taken steps to widen their resource base and mobilise funds on domestic as well as international markets.

Prudential Norms : The DFIs have recognised the importance of prudential norms as a means to maintain financial health and have also been following norms for credit concentration, asset classification, income recognition and provision for bad debts. In March, 1994, RBI issued guidelines on prudential norms to be followed by DFIs in India. These norms are similar to the norms issued to the commercial banks.

Diversification of Operations : In tune with the changing environment, the DFIs have been diversifying their operations and reorienting their business strategies.

Rationalisation of Interest Rates : Interest regime has become more liberalised. DFIs have also amended the norms regarding promoter's contribution and debt-equity to increase promoter's stake in projects. Convertibility clause is no longer obligatory for assistance sanctioned by term lending institutions.

Impact of Reforms :

One has begun to see the impact of financial sector reforms, both on the financial results as well as in the services provided. Operating profits have gone up from Rs. 7,568 crore in 1995-96 to Rs. 13,992 crore in 1998-99 and net profit from loss of Rs. 371 crore to a net profit Rs. 4,660 crore. All banks except two have met the minimum capital adequacy ratio. As on March 31st, 1999 CRAR of public sector banks as a whole was 11.2 per cent. However, all public sector banks except one achieved CRAR of 9 per cent as on March 31st 1999 a number of banks have entered the capital market to satisfy the capital adequacy norm.

Reduction in NPAs has acquired more focussed attention. The level of NPAs is no doubt high but the percentages are showing a decreasing trend. The percentages vary sharply among banks. Percentage of gross NPAs have come down from 23 per cent in 1992-93 to 14.6 per cent in 1998-99. Net NPAs of Schedule commercial banks declined marginally from 3 per cent

of their total assets as on March 31st, 1998 to 2.9 per cent as on 31st March, 1999. In the case of foreign banks net NPAs declined from one percent of their total assets as on 31st March, 1998 to 0.8 per cent as on 31st March, 1999. As the built-up of NPAs has been a major factor in the erosion of profitability of public sector banks in India, the Narasimham Committee (II) underscored the need to reduce the average level of net NPAs for all banks to 3 per cent by 2002. The priority sector advances accounted for 47 percent of the total NPAs and non-priority sector for the balance.

Activity - D

Assuming that you are a Manager of a bank state whether the measures taken by the Government and RBI for reforming the financial sector are appropriate. What suggestions would you like to give for further reforming the financial sector in India ?

16.6 TOWARDS SOUND FINANCIAL SECTOR

The financial sector reforms in India are an integral part of the overall programme of economic reforms aimed at improving productivity and efficiency of financial institutions. In fact, the efficiency of the reforms in the economy would have blunted without corresponding reforms in the financial system and hence Government was required to take them simultaneously. The Government of India and the RBI already started reforming the banking sector, DFIs, money and capital markets even though the Government is finding it difficult to enforce changes. For reforms to be effective, honest and since efforts are necessary, not just facade of doing so. Reforms cannot be half-hearted nor piecemeal, and having accepted change, the Government and the Institutions have to work with conviction and commitment.

The recent financial crisis in South-East Asia and Japan amply demonstrated how a weak and fragile domestic financial sector could lead to serious problems for the real economy. These economics bear testimony to the fact that a persistent and unexpected downturn in the real economy creates difficult problems for the financial sector. A fragile financial sector or banking system can deepen further the real economic crisis in imposing heavy social costs in terms of unemployment, retardation in output growth, higher inflation etc. It is, therefore, imperative to strengthen the banking system through prudential norms, such as capital adequacy, income recognition and provisioning norms for banks, particularly to move towards full disclosure and transparency in banking operations in line with international best practices.

16.7 SUMMARY

This unit was devoted to discuss the need for bringing out certain reforms in the Indian financial sector, which lead to the constitution of Narasimham Committee. The important recommendations of Narasimham Committee, both first and second phases, were explained. Various steps initiated by the Government to implement the recommendations of Narasimham Committee like changing the SLR & CRR, developing prudential norms, capital adequacy norms etc., were also explained in detail.

16.8 SELF-ASSESSMENT TEST

1. Critically evaluate the reforms undertaken in India for reforming the financial sector.
 2. Explain the need for the implementation of second phase of reforms.
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16.9 FURTHER READINGS

1. Economic Survey, 1994-95, Government of India Publication.
2. Economic Survey, 1999-2000, Govt of India Publications.
3. Report of the Narasimham Committee, Nabhi Publication, New Delhi, 1993.
4. Report of the Narasimham Committee, 1998.
5. C. Rangarajan, The Reform of the Financial Sector : Choices and Lessons, RBI Monthly Bulletin, December, 1994.

BRAOU

BLOCK -IV : EXTERNAL SECTOR

Foreign exchange plays a crucial role in the economic development of any country. To earn more and more foreign exchange, the country should encourage its exporters and discourage importers. In addition to foreign exchange, foreign capital also is equally essential for development of any economy.

In this backdrop, all the 4 units in this block are devoted to explain the importance of foreign exchange and foreign capital. Unit-17 explains you about India's foreign trade and also the EXIM policy of our country. Unit-18 is devoted to discuss the Balance of Payments position in India, the problems involved in it, the recent trends in it, etc.

What is foreign capital? How to collaborate with foreign countries? What is our country's foreign investment policy? - All these aspects are explained in unit-19.

Unit-20 deals with MNCs, strategies MNCs, process of internationalisation of a MNC etc.

BRAOU

UNIT-17: INDIA'S FOREIGN TRADE AND EXIM POLICY

Objectives

This unit facilitates you to learn :

- dimensions of foreign trade and trade policy;
- trends, structure and direction of India's foreign trade;
- major features of India's restrictive import regime and export promotion measures;
- India's trade liberalisation in the 90s; and
- the implications and dimensions of India's growing foreign trade and intensifying trade reforms.

Structure :

- 17.1 Introduction
- 17.2 India's Foreign Trade : Trends, Composition and Direction
- 17.3 India's Exim Policy : Background
- 17.4 India Exim Policy (1950-90) : Highlights of Import Regime and Export Promotion Strategy
- 17.5 India's Exim Policy in the 90s : Major Developments
- 17.6 India's Exim Policy : Recent Changes
- 17.7 Summary
- 17.8 Self-Assessment Test
- 17.9 Further Readings

17.1 INTRODUCTION

Foreign trade refers to trading of goods between countries : exporting of goods to other countries and importing some other goods from other countries. Thus foreign trade which is also known as international trade, is an extension of inter-regional trade, that is trade between different regions within a country.

International trade confers on an economy several benefits. Firstly, it benefits the national economy by enabling a country to specialise in the production of those goods for which it is best suited, considering its natural resources, labour skills and capital assets. It can export these commodities in exchange for what other countries can produce at a lower cost. Thus, international trade provides maximum scope for the optimum exploitation and allocation of world's scarce resources.

For example, the unprecedented prosperity enjoyed by the OPEC (Organisation of Petroleum Exporting Countries) nations would have been impossible but for the ready world demand for their petrol and petroleum based products made possible by international trade. But for international trade, their vast petrol reserves would have remained unexploited and these countries would have remained as world's poorest countries.

Secondly, international trade changes the quality of labour through the transmission of new ideas, import of technical know-how, managerial talents and entrepreneurship. It also changes the quality of life of people, teaches them to consume new things and use old things in new ways.

Further, foreign trade facilitates the dissemination of technical knowledge, which is largely the result of specialisation, which trade has made possible.

But, there are some arguments which are advanced against international trade :

- A country which depends on imports is in a vulnerable position during war.
- International trade is a source of economic instability and interferes with national economic planning.
- International trade inflicts losses on those home industries whose products are displaced by imports.

Nonetheless, it is admitted that one single economy cannot produce every commodity it wants by itself. This could be due to differences in the availability of natural resources, skills of people, etc. That is why, today, almost every country in the world is engaged in foreign or international trade.

It is to use foreign trade to maximize the economic benefits for the home country that every country has its own trade policy or exim policy. Trade Policy or Export-Import (EXIM) Policy refers to policies of the Government of a country adopted with reference to exports and imports. Trade Policy may be free trade policy or protective/restrictive trade policy. Free trade policy does not impose any restriction on the exchange of goods between countries. It does not impose any tariff, quota, taxes, or subsidies on production, factor use and consumption.

Protective trade policy refers to the imposition of quantitative (eg. quota) and / or non-quantitative (eg. tariff) restrictions on imports and exports, with the objective of protecting domestic economy from the competition of foreign products.

Trade policy may be outward looking or inward looking. Outward looking trade policy encourages free trade, free movement of capital, enterprise, students and labour, whereas inward looking trade policy restricts the movements of goods, services and people between countries. An inward looking trade policy aims to promote the development of indigenous technologies and economic self-reliance.

Trade policy will have a strong influence on the direction, composition, and growth trends of foreign trade of a country. This, in turn, will affect its economic development process, particularly if foreign trade forms a larger component of its overall economic activity.

17.2 INDIA'S FOREIGN TRADE : TRENDS, COMPOSITION AND DIRECTION

Trends :

Foreign trade forms an important component of Indian economy. At the time of independence, India being primarily backward agricultural economy, exported agricultural raw materials and imported industrial machinery and other manufactured goods. However, since then, the value, volume, composition and direction of India's exports as well as imports have undergone remarkable changes.

India's foreign trade has increased impressively in absolute value terms since 1949-50 (Table-17.1). The values of exports as well as imports have increased by more than 250 times

over the period of last five decades: 1949/50-1998/99. The value of exports, which was Rs. 485 crore in 1949-50, increased to reach Rs. 141604 crore in 1998-99. The value of imports, during the same period rose from Rs. 617 crore to Rs. 176099 crore.

An important feature of India's foreign trade in the post - independence era is that India has always had deficit trade balance: that is, the value of imports has always been higher than the value of exports. The exceptions were 1972-73 and 1976-77, in which the value of exports exceeded the value of imports.

Another feature of India's international trade is the fluctuating growth rates of both exports and imports. The growth rate varied from 42.9 percent in 1966-67 to -19.3 percent in 1952-53 for exports and from 58.3 percent in 1973-74 to -21.1 percent in 1952-53.

In the 90s, however, there was a more stable growth of both exports and imports, particularly till 1996-97. The values of both exports and imports increased by more than four times during 1990/91-1998/99. But this increase could be partly attributed to the devaluation and depreciation of Indian rupee in the foreign exchange market.

Table-17.1
Exports, Imports and Trade Balance

Year	Exports (including re-exports)	Imports	Trade Balance	Rates of Change(Per cent)	
				Export	Import
1949-50	485	617	-132		
1950-51	606	608	-2	24.9	-1.5
1951-52	716	890	-174	18.2	46.4
1952-53	578	702	-124	-19.3	-21.1
1953-54	531	610	-79	-8.1	-13.1
1954-55	593	700	-107	11.7	14.8
1955-56	609	774	-165	2.7	10.6
1956-57	605	841	-236	-0.7	8.7
1957-58	561	1035	-474	-7.3	23.1
1958-59	581	906	-325	3.6	-12.5
1959-60	640	961	-321	10.2	6.1
1960-61	642	1122	-480	0.3	16.8
1961-62	660	1090	-430	2.8	-2.9
1962-63	685	1131	-446	3.8	3.8
1963-64	793	1223	-430	15.8	8.1
1964-65	816	1349	-533	2.9	10.3
1965-66	810	1409	-599	-0.7	4.4
1966-67	1157	2078	-921	42.8	47.5

Year re-exports)	Exports (including Imports Trade Balance		Rates of Change(Per cent)		
	Export	Import	Export	Import	
1967-68	1199	2008	-809	3.6	-3.4
1968-69	1358	1909	-551	13.3	-4.9
1969-70	1413	1582	-169	4.1	-17.1
1970-71	1535	1634	-99	8.6	3.3
1971-72	1608	1825	-217	4.8	11.7
1972-73	1971	1867	104	22.6	2.3
1973-74	2523	2955	-432	28.0	58.3
1974-75	3329	4519	-1190	31.9	52.9
1975-76	4036	5265	-1229	21.2	16.5
1976-77	5142	5074	68	27.4	-3.6
1977-78	5408	6020	-612	5.2	18.6
1978-79	5726	6811	-1085	5.9	13.1
1979-80	6418	9143	-2725	12.1	34.2
1980-81	6711	12549	-5838	4.6	37.3
1981-82	7806	13608	-5802	16.3	8.4
1982-83	8803	14293	-5490	12.8	5.0
1983-84	9771	15831	-6060	11.0	10.8
1984-85	11744	17134	-5390	20.2	8.2
1985-86	10895	19658	-8763	-7.2	14.7
1986-87	12452	20096	-7644	14.3	2.2
1987-88	15674	22244	-6570	25.9	10.7
1988-89	20232	28235	-8003	29.1	26.9
1989-90	27658	35328	-7670	36.7	25.1
1990-91	32553	43198	-10645	17.7	22.9
1991-92	44041	47851	-3810	35.3	10.8
1992-93	53688	63375	-9687	21.9	32.4
1993-94	69751	73101	-3350	29.9	15.3
1994-95	82674	89971	-7297	18.5	23.1
1995-96	106353	122678	-16325	28.6	36.4
1996-97	118817	138920	-20103	11.7	13.2
1997-98	130101	154176	-24076	9.5	11.0

Year	Exports (including re-exports)		Rates of Change(Per cent)		
	Imports	Trade Balance	Export	Import	
1998-99	139853	178332	-38580	7.4	15.7
1999-2000	162925	204583	-41658	16.6	14.7

Source : 1. Economic Survey, 1998-99
 2. Economic & Political Weekly, Vol. 34 Nos. 42 and 43. October 16/22-23/29, 1999

Another positive development on the trade front in the 90s, is the marginal increase in the relative share of India's exports in total world exports (Table-17.2). India's share in world exports, despite remarkable growth of exports over the period, has been negligible. India's relative share was a meagre 0.6 percent in 1970 and it declined to 0.4 percent in 1980. By 1990, it increased again to 0.5 percent. In 1996, the share went up further to 0.7 percent but declined to 0.6 percent in 1998.

Table-17.2 : India's Exports Vs World Exports

Year	Exports in US \$ Million		India's Share in World Exports
	World	India	
1970	313804	2031	0.6
1975	876094	4665	0.5
1980	1997686	8486	0.4
1985	1930849	8904	0.5
1990	3303563	18143	0.5
1994	4139600	26330	0.6
1996	5082220	33470	0.7
1998	5075047	32039	0.6

Source : Economic Survey, 1998-99

India's minor share in world exports is due to lack of competitiveness in terms of price and quality of Indian goods in the international market. The fact that there is a marginal increase in the relative share in the 90s may be an indication that there has been a minor improvement in India's competitiveness vis-a-vis international market.

Composition

Trade composition refers to the variety commodities exported and imported by a country. The composition of foreign trade is important because it reveals the state of economic development of a particular economy. A backward agricultural economy's exports might comprise only agricultural raw materials and commodities whereas imports will include manufactured goods, particularly machinery, transport equipments etc.

A relatively more developed economy might export light manufactured items such as processed foods, textiles and garments, leather products, handicrafts, etc. and import heavy manufactured goods like capital equipments, components of consumer durables, computers, etc. An industrialised/developed economy's exports will consist of heavy manufactured goods and import agricultural and related commodities, light manufactured items, etc. Thus, in the process of economic development and industrialisation, the composition of exports as well as imports is likely to undergo transformation.

India's composition of imports as well as exports has undergone structural changes during 1960/61 - 1997/98 (Tables-17.3 and 17.4). India's imports broadly comprise (i) food items, (ii) raw materials and intermediate manufactures, and (iii) capital goods. In 1960-61, food items accounted for about one-fifth of the value of imports. But since then, the value of food items as a percentage of total imports has declined. Today, food imports account for hardly 5 percent of India's import bill. This reflects the self-sufficiency achieved by India in food grains, over the period of time.

The most valuable component of India's imports is raw materials and intermediate manufactures. This, in turn, includes (1) Petroleum, Oil and Lubricants (P.O.L.) (2) Fertilizers and Chemicals, (3) Pearls, Precious and Semi-Precious Stones, (4) Iron & Steel, and (5) Non-Ferrous Metals. While the relative share of raw materials and intermediate manufacturers has registered an increase since the 60s, the relative significance of the five sub-components mentioned above has varied over time.

Table-17.3
Composition of India's Imports : 1960/61 - 1997/98
(% Share in value)

Major Items	1960/61	1970/71	1980/81	1990/91	1997/98
I. Food and Related Items	19.07	14.81	3.03	N.A.	4.1
II. Raw Materials and					
Intermediate Manufacturers:	47.82	54.41	77.78	N.A.	N.A.
-Petroleum, Oil and Lubricants (P.O.L.)	6.15	8.32	41.95	25.04	20.15
-Fertilizers and Chemical Products	7.84	13.28	11.87	N.A.	N.A.
-Pearls, Precious and Semi Precious Stones	0.10	1.53	3.32	8.65	7.71
-Iron & Steel	11.00	9.00	6.79	4.89	3.69
-Non-Ferrous Metals	4.20	7.28	3.80	2.55	2.23
III. Capital Goods	31.73	24.72	15.22	24.22	17.51
IV. Other Items(Unclassified)	2.23	6.06	3.98	N.A.	N.A.
Total	100.00	100.00	100.00	100.00	100.00

Source : Economic Survey, 1998-1999

Table -17.4
India's Export Composition : 1960/61 - 1997/98
(% Share in Value)

Major Items	1960/61	1970/71	1980/81	1990/91	1997/98
I. Agriculture & Allied Products	44.24	31.73	30.65	19.41	18.76
II. Ores and Minerals	8.10	10.68	6.17	4.60	2.39
III. Manufactured Goods	45.33	50.29	55.83	72.91	76.65
-Textiles and Fabrics	11.37	9.44	13.90	21.00	23.76
-Readymade Garments	0.16	1.90	8.20	12.32	11.11
-Jute Manufactures	21.03	12.38	4.92	0.92	0.29
-Leather Products	4.36	5.21	5.81	8.00	4.32
-Handicrafts	1.71	4.76	14.19	18.94	N.A.
-Machinery, etc.	3.43	12.90	12.32	11.89	14.53
IV. Mineral Fuels & Lubricants	1.09	0.85	0.42	2.91	1.14
V. Others	1.25	6.51	6.94	0.17	0.28
Total	100.00	100.00	100.00	100.00	100.00

The most important of all these in P.O.L. Due to an increase in the international oil prices and also due to steady increase in domestic demand, the P.O.L. share of imports went up from about six percent in 1960-61 to almost 42 percent in 1980-81. Since then, though the relative share has come down, it fluctuates from year to year, largely depending on the international prices. Today P.O.L. imports accounts for about one-fifth to one-fourth of the value of imports. P.O.L. imports will continue to be a major component of India's imports in the future, unless and until India achieves a major break through in its oil exploration and production.

Another item which has, more or less, consistently increased its share in the import bill is pearls and precious stones. These are used mainly by the gems and jewellery industry and are exported, after value addition (through cutting and polishing).

The import of iron and steel and non-ferrous metals has steadily declined since the 60s whereas the import of fertilizers and chemicals has increased.

Another important item of imports is capital goods. The fact that India does not have a sound indigenous technology base, compels domestic industry to resort to import of capital goods of various kinds from year to year. Like P.O.L., capital goods will continue to account for a significant share of the value of imports in the future as well.

On the whole, the change in the composition of India's imports (1960/61 - 1997/98) is characterised by a steady decline of food items and a steady increase of manufacturing intermediates and raw materials.

The composition of India's exports broadly falls under (i) agriculture and allied products, (ii) ores and minerals, (iii) manufactured goods and (iv) mineral fuels and lubricants. Of these agricultural items and manufactured goods are significant. In the beginning of the 60s, both agricultural items and manufactured goods accounted for almost an equal share of exports. However, since then the export of agricultural items declined steadily whereas the export of

manufactured goods, particularly (1) textiles and fabrics, (2) ready made garments, (3) handicrafts which includes gems and jewellery, and importantly (4) machinery, increased considerably. As a result, manufactured goods, which had a share of about 45 percent of the value of exports in 1960-61, accounted for as much as 77 percent of the value of exports in 1997-98. Among the manufactured items, Jute manufacturing exports has rapidly declined from about 21 percent in 1960-61 to a meagre 0.29 percent 1997-98, reflecting the deteriorating status of the industry.

Thus, India's export growth has been characterised by the relative decline of traditional agricultural items and faster growth of non-traditional manufacturing items, including machinery.

Direction

India has trading relations with almost all the countries around the world. However, to understand the sources of India's imports and destination of India's exports, countries of the world are classified under five broad groups:

1. Countries which form the Organisation for Economic Co-operation and Development (OECD) and which represent the developed world:
 - European community which includes, among others, Belgium, Germany and United Kingdom.
 - North America which includes Canada and U. S. A.
 - Australia and Japan.
2. Organisation of Petroleum Exporting Countries (OPEC) consisting of Iran, Iraq, Kuwait and Saudi Arabia.
3. Eastern Europe covering Romania, etc.
4. Developing countries of Africa, Asia, and Latin America.
5. Other countries.

Majority of India's imports originate from OECD countries (Table-17.5). In 1960-61, as much as 78 percent of the import originated from OECD countries, particularly USA, UK and Germany. However, over the period the significance of OECD as a trading partner has declined relatively. In 1997-98, approximately 50 percent of India's imports were sourced from OECD. The importance of USA, UK and Germany, as the source of imports has declined in the last four decades. Whereas Belgium and Australia have become relatively more important sources of imports.

Table-17.5
Sources of India's Imports : 1960/61 - 1997/98
(Percentage Share)

Countries	1960/61	1970/71	1980/81	1990/91	1997/98
I. OECD :	78.00	63.80	45.70	54.00	49.90
A. EC	37.10	19.60	21.00	29.40	23.00
- Belgium	1.40	0.70	2.40	6.30	6.00
- Germany	10.90	6.60	5.50	8.00	6.10
- U.K.	19.40	7.80	5.80	6.70	5.70
B. North America	31.00	34.90	14.70	13.40	10.00
- U.S.A.	29.20	27.10	12.90	12.10	8.90
C. Other OECD Countries :	7.10	7.40	7.40	11.20	9.10
- Australia	1.60	2.20	1.40	3.40	3.70
- Japan	5.40	5.10	6.00	7.50	5.20
II. OPEC	4.60	7.70	27.80	16.30	23.10
III. Eastern Europe	3.40	13.50	10.30	7.80	2.10
IV. Developing Countries :	11.80	14.60	15.70	18.40	21.80
- Asia	5.70	3.30	11.40	14.00	13.40
V. Others	2.20	0.50	0.50	3.50	0.70
Total	100.00	100.00	100.00	100.00	100.00

Source : Economic Survey, 1998-99

On the other hand, imports from OPEC and developing countries have increased remarkably. In 1960-61, these two groups accounted for about 15 percent of India's imports but in 1990/91 and 1997/98, imports from these countries went up to about 35 per cent and about 45 percent respectively. What is significant is that, India's imports from Asian countries have more than doubled in the last four decades.

The direction of India's exports over the period present more or less, a similar scenario (Table-17.6). In 1960/61, OECD countries were the major destination for India's exports, absorbing more than 66 per cent of the total exports. Their relative importance declined since then till 1980/81. But in the 90s, their share in India's exports, has again showed an upward trend, particularly that of the U.S.A.

Eastern Europe including Russia was an important market for India's exports from the 70s till the beginning of the 90s. However, with the distintegration of the U.S.S.R., and the decline of controlled economies in Eastern Europe in the early 90s, its importance as a destination for India's exports has considerably reduced. The export to developing countries, particularly Asian countries has increased remarkably during the last four decades.

All these bring out that since independence :

- India has strengthened its trade relations with its Asian neighbours much more than with the rest of the world.

- India's trade relationship with South American and African countries is negligible.
- Though the significance of OECD countries as a trading partner has declined since the 60s, among the OCED countries, U.S.A. is emerging as a major market for India's exports.
- OPEC has a special role in India's foreign trade as they supply the indispensable Petroleum, Oil and Lubricants (P.O.L).

Table 17.6

Sources of India's Imports : 1960/61 - 1997/98

(Percentage Share)

Countries	1960/61	1970/71	1980/81	1990/91	1997/98
I. OECD :	66.10	50.10	46.60	53.50	55.70
A. EC	36.20	18.40	21.60	27.50	25.20
- Belgium	0.80	1.30	2.20	3.90	3.50
- Germany	3.10	2.10	5.70	7.80	5.50
- U.K.	26.90	11.10	5.90	6.50	6.00
B. North America	18.70	15.30	12.00	15.60	20.70
- U.S.A.	16.00	13.50	11.10	14.70	19.50
C. Other OECD Countries :	10.10	15.20	10.60	10.40	6.90
- Australia	3.50	1.60	1.40	1.00	1.30
- Japan	5.50	13.30	8.90	9.30	5.50
II. OPEC	4.10	6.40	11.00	5.60	10.00
III. Eastern Europe	7.00	21.00	22.10	17.90	3.10
IV. Developing Countries :	14.80	19.80	19.20	16.80	28.20
- Asia	6.90	10.80	13.40	14.30	21.30
V. Others	8.00	2.60	1.00	6.20	3.00
Total	100.00	100.00	100.00	100.00	100.00

Source : Economic Survey, 1998-99

17.3 INDIA'S EXIM POLICY : BACKGROUND

India's Trade Policy or Exim Policy was largely influenced by the objective of economic self-reliance, since independence till the 90s. Further, the strategy towards trade policy was determined by the necessity to conserve scarce foreign exchange reserves and to ensure its use only for essential purposes for accelerating economic development.

Towards this, import substitution and protection to domestic industrialization through a system of tariff and non-tariff controls were pursued in India's Exim Policy for most of the period during 1950/51 to 1990/91.

Since 1990/91, however, India's trade policy has been undergoing liberalization in the form of dismantling import restrictions, and consistent reduction in tariff rates. To achieve economic self-reliance, the strategy of import substitution has given way to "paying for imports from the earnings of exports". Thus, India's trade policy has undergone a radical shift in the 90s as compared to the earlier period : from controls and regulations to liberalization.

Further, India's Exim Policy was announced annually till 1985. In April 1985, in a significant departure, the Government announced new Export-Import Policy for a period of three years with the objective of removing uncertainty and bringing stability to the policy. In March 1992, the duration of the policy was increased from three to five years. However, in reality the Government did not restrain itself from announcing changes in the exim policy from time to time.

17.4 INDIA'S EXIM POLICY (1950-90) : HIGHLIGHTS OF IMPORT REGIME AND EXPORT PROMOTION STRATEGY

Import Regime

India's import regime had two major dimensions : (i) non-tariff controls and (ii) tariffs.

Non-tariff controls were aimed at regulating imports and protecting local industries. The non-tariff controls comprised (1) Import licensing, (2) Canalization, (3) Actual user policy, and (4) Phased Manufacturing Programme (PMP).

For the purpose of import licensing, imports were classified under : (1) consumer goods, (2) capital goods, and (3) intermediates. Import of consumer goods was generally banned. Only in time of shortfall of domestic production, items such as food grains, edible oil, drugs and medicines were allowed to be imported.

Capital good were divided into "restricted category" and "Open General License (OGL) category". Import license was required to import any item listed in the "restricted category" and items not listed in the "OGL" category. OGL items could be imported without a license, provided the importer is the actual user of the imported machinery.

Intermediate goods imports were classified into banned, restricted, limited permissible and OGL categories. Items which were not in the banned/restricted/limited permissible lists or in the list of canalised items, could be imported without a license.

There were some imports which were allowed only through Government owned agencies, as listed in the Exim Policy. These agencies are called canalising agencies and the process of imports through these agencies is called canalisation (Table-17.7).

Table-17.7 : Canalising Agencies and Imports

Agency	Import Items
1. Indian Oil Corporation (I.O.C.)	Petroleum, Oil and Lubricants (P.O.L.)
2. Mineral and Metals Trading Corporation (M.M.T.C.)	Iron & Steel, Fertilisers and Non Ferrous Metals
3. State Trading Corporation (S.T.C.)	Edible Oil, Sugar, Cement, News print etc.
4. Food Corporation of India (F.C.I.)	Cereals
5. Metal Scrap Trading Corporation (M.S.T.C.)	Scrap metal
6. Cotton Corporation of India (C.C.I.)	Cotton

According to the actual user policy, import of certain goods were allowed through import licenses only for the actual user of that capital or intermediate product.

Finally, the phased manufacturing programme (PMP) made it obligatory for a manufacturing unit to gradually and steadily replace imported materials, parts and components by materials, parts and components produced in-house or produced by other Indian firms. PMPs were applicable to industries which involve assembling of parts and components such as vehicles, electronics and machinery industries.

Tariff restrictions refer largely to customs duties. The level and structure of customs duties varied from commodity to commodity. However, prior to 1990s, India was one of the very few countries which had a very high level of import duties, absolutely as well as relative to the rest of the world, particularly developing countries. Whether intermediates, capital goods, or consumer goods or manufactured goods as a whole, the average level of import duty in India was rather one of the highest in the world in the mid eighties (Table-17.8).

Table-17.8

**Level of Import Duty in India vis-a-vis Other Countries :
Nominal Tariff Rates, 1985**

Country	Capital Goods	Consumer Goods	Intermediates	Manufactured Goods
Hungary	15.0	22.6	14.2	20.9
Argentina	20.7	20.0	18.0	19.0
Morocco	18.1	43.0	21.6	27.3
Philippines	24.5	39.0	21.8	28.0
Thailand	24.8	8.5	27.8	33.6
Pakistan	73.8	127.3	75.0	89.8
China	62.5	130.7	78.9	91.2
India	107.3	140.9	146.4	137.7

Source : "India Survey". The Economist, May 4-10, 1991, p-9

Export Promotion Strategy

India's export promotion strategy primarily aimed at enhancing the competitiveness of India's exports through :

- I. Schemes for providing imported inputs and capital equipments at a reduced rate, and subsidising domestic raw materials.
- II. Product specific Export Promotion Councils.
- III. Export Trading Houses.
- IV. Institutions to promote trade, to ensure the availability of credit, credit insurance, etc.
- V. Free Trade Zones (FTZs) and Export Oriented Units (EOUs).

Imported Raw Materials and Capital Goods

To ensure the availability of raw materials at competitive prices, exporters were provided special import licenses. This enabled them to import certain restricted raw materials and components, upto specified percentage of exports. The import licenses were issued on the basis of export contracts or past export performance and the imported materials must be actually used in the production of items for exports.

The exporters while importing the raw materials through special import licenses, pay the normal customs duty and claim refunds through what was known as "duty drawback scheme". The duty drawback scheme allowed the refund of excise, sales and other indirect taxes, in addition to customs duties, included in the cost of domestically purchased raw materials. Further, exporters were provided cash compensatory support (CCS), which compensated the exporter for domestic taxes such as excise duties and sales taxes included in the cost of electricity.

In the late 80s, Government introduced Import-Export Pass Book Scheme to streamline the import procedures for exporters by providing them duty free access to imported inputs. The scheme was applicable to only registered manufactured exporters.

In addition to raw materials, Government had liberalized the import of capital goods and reduced the associated tariffs in the mid 70s. The objective was to make available state-of-the-art imported machinery at competitive rates for export oriented industries.

Further, schemes were introduced to subsidize domestic raw materials to bring them on par with the prices of international market.

The overall objective of providing subsidized/duty free domestic/imported raw materials and capital goods was to ensure that exporters produce internationally competitive products, in terms of price as well as quality.

Export Promotion Councils

Developing exclusive institutional network for the promotion of export of different product categories was another dimension of India's export promotion strategy. Over the period of time, Government had promoted 18 industry specific Export Promotion Councils. Eg. Apparel Export Promotion Council (AEPC) to promote garment exports, Engineering Export Promotion Council (EEPC) to promote the export of engineering goods, Agriculture and Processed Foods Export Development Authority (APEEDA), etc.

Export/Trading Houses

To facilitate marketing of goods of small and medium and even large enterprises, in the international market, Government introduced the concept of export houses, which could be promoted by private sector. In early 80s, Government encouraged the coming of larger trading houses, i.e. companies who export goods of a minimum value on a consistent basis.

Institutions to Promote Trade/Finance/Insurance

Institutions were created to promote trade, availability of finance and provide insurance protection (Table-17.9)

Table - 17.9 : Export Promotion Related Institutions

Institution	Function
Trade Fair Authority (T.D.A.)*	To probe trade opportunities, maintain trade statistics, provide trade information etc.
Trade Fair Authority of India (T.F.A.I.)*	To conduct exhibitions in India and abroad - to exhibit and promote exports of Indian products, promote trade contracts, etc.
Export Import of Bank of India (EXIM Bank)	Credit supply to exporters and importers through its state level branches across the country and abroad, conducts trade relevant training programmes, etc.
Export Credit & Guarantee Corporation (ECGC)	Provides export credit guarantee to banks and credit insurance for exporters.

* In 1994, T.D.A. and T.F.A.I. were merged together to form Indian Trade Promotion Organisation (I.T.P.O).

Free Trade Zones and EOUs

Free Trade Zones or Export Processing Zones (EPZs) are exclusive areas demarcated and developed with all the basic infrastructure for manufacturing units for export production. The rationale behind the promotion of EPZs is that export production can be initiated without adjusting or transforming the regime of protection meant for manufacturing units producing for the domestic market. EPZs are treated as operating outside the domestic tariff area, and hence have the right to import all their requirements, including capital goods, parts and components, intermediates and raw materials free of import licensing requirements and customs duties.

Among the developing countries, India was the first to set up an EPZ in 1965 in Kandla. In 1974, the Santacruz Electronic Export Processing Zone (SEEPZ) was set up near Mumbai. In the 80s, four more EPZs were created - one each in Chennai, Kochi, Nodia in Uttar Pradesh and Falta in West Bengal.

The objective of an EPZ is to promote a free trade environment for manufacturing units which are engaged in the task of production for exports. An EPZ is free from bureaucracy and administrative controls. It allows the entry of foreign enterprises without restrictions for setting up export units.

Unlike a Free Trade Zone, an Export Oriented Unit (EOU) can come up anywhere in the country. The EOU scheme was introduced in 1981. According to the scheme, single point clearance is provided with regard to industrial licensing and foreign collaborations and duty free access to imports is granted, provided the EOU obliges the following :

Entire output (100 per cent) should be exported, and

At least 20 per cent of the export value must be accounted by domestic value addition.

However, despite the restrictive import regime and institutions-cum-incentives based export promotion strategy, India could not prevent the deteriorating trade deficit. India could not achieve the objective of economic self-sufficiency through import substitution nor its industry could become internationally competitive. Prolonged protection from external competition made industry complacent with in turn resulted in technological obsolescence, cost escalation and deterioration of quality.

17.5 INDIA'S EXIM POLICY IN THE 90S : MAJOR DEVELOPMENTS

The external crisis of deteriorating balance of payments position and internal crisis of worsening fiscal deficit forced the government of India to adopt an altogether different strategy for economic development in 1991. This led to the initiation of economic reforms, with the introduction of radical industrial and trade liberalisation measures.

During July-August 1991, Government announced far-reaching changes in trade policy. The changes comprised substantial liberalisation of controls and licenses, decanalisation of many items, reduction in peak tariff rates, etc. Actual user policy for imports and phased manufacturing programmes were abolished. Foreign equity participation upto 51 per cent in trading houses was permitted. The process of liberalising, decanalisation and reducing import duties was progressively intensified in the subsequent years.

In addition, in 1992-93, Government introduced a new system of exchange rate management : Liberalised Exchange Rate Management System (LERMS). According to this system, 40 per cent of the proceeds of exports and inward remittances were to be surrendered to the Reserve Bank of India at the official exchange rate and the rest could be converted at the market exchange rate. LERMS was introduced as a prelude to the subsequent full rupee convertibility on trade account. LERMS facilitate further import liberalisation for exporters.

In 1993, transactions on trade account were freed completely from exchange control. The determination of the exchange rate of rupee was left to the market. As a result, since then, unlike in the past, importers and exporters cannot approach the Reserve Bank of India for their foreign exchange requirements. They have to buy the required foreign currency from the market for their trade transactions.

The major objectives of the Exim Policy in the 90s were to (1) phase out quantitative restrictions in the form of licensing and other discretionary controls, and (2) continuously scale down the tariff barriers. These objective have been met to a large extent :

- In 1991, import of items was allowed by a positive list of freely importable items. Since 1992, import was regulated by a limited negative list which was pruned consistently. In July 1991, about 4000 out of 5021 tariff items were subject to import licensing. By 1995, more than 3000 items were brought out of the purview of import licensing requirements.
- Customs duty rates were brought down substantially across the board. The peak rate, which was 300 per cent in 1990, was reduced to 40 per cent by 1997. This was further brought down to 35 per cent and the total number of slabs in customs duty rates was rationalized from five to four (i.e. 35, 25, 15 and 5 percent) in 2000.
- Duty on various items (mostly consumer goods and agriculture products) on which quantitative restrictions have been lifted have been placed at peak rate to accord adequate tariff protection to these items.
- Phasing out of export concessions under Income Tax over a period of five year (2000-2005).
- Gradual removal of quantitative restrictions (QRs) on imports. By 1999, the number of tariff lines on which QRs exist came down to 1429 at the eight digit level. In 2000, QRs on another 714 tariff lines were removed, which included 58 reserved items for the SSI sector.

- Setting up of Special Economic Zones (SEZs) to encourage export production with fewer rules and regulations governing imports and exports. The units operating in SEZs are deemed to be outside the country's customs territory and have full flexibility of operations. They can import capital goods and raw materials duty free and can access the same from Domestic Tariff Area (DTA) without payment of excise duty. No permission is needed for inter unit sales or transfer of goods. The movement of goods between SEZs and ports are unrestricted. The units in SEZs have to be net foreign exchange earners.
- The duty payable under the Export Promotion Capital goods (EPCG) scheme was reduced from 15 percent to 10 percent.
- EOUs/EPZ units in the agro-sector were allowed to sell 50 per cent of their output in the domestic tariff area (DTA) without stipulation of any value addition.

All these imply that India has been making concerted efforts towards globalising the economy by progressively freeing importers and exporters from controls and regulations and consistently reducing the tariff level to make it comparable to international standards. Thus, in the 90s, Indian economy, particularly the producers have been exposed to international competition gradually and steadily.

17.6 INDIA'S EXIM POLICY : RECENT CHANGES

Trade Policy reforms implemented over the last decade (1991-2000) created an export friendly environment with simplified procedures conducive to enhancing export performance. The focus of these reforms have been liberalization and globalization with thrust on export promotion, moving away from quantitative restrictions.

The current exim policy which is in operation is the Exim Policy (1997-2002) which was announced on 31st March 1997. Since then, the exim policy has been revised annually. The exim policy announced on 31st March 2001 is the last revision in the current policy.

The most important feature of the Exim Policy, 2001-2002 is the total lifting of quantitative restrictions (QRs) on imports. QRs refer to measures other than tariffs or duties (eg. quotas, licenses, canalisation) taken to restrict imports (or exports). Although multilateral trade rules in general prohibit QRs on import (or export) of goods, the GATT provided exceptions to this rule on the ground of Balance of Payments difficulties and allowed imposition of QRs on imports. India thus maintained QRs on imports on B.O.P. grounds but due to improvement on the B.O.P. front, committed to phase out QRs by 2003. But the U.S.A. filed a case in the World Trade Organization (W.T.O) Dispute Settlement Body (DSB) against these QRs in 1997. The DSB ruled in favour of the U.S. and found India's QRs on imports unjustified on B.O.P. ground. It recommended that India should bring its imports on conformity with its obligations under the W.T.O. Accordingly, India has phased out QRs on imports with effect from 1st April 2001.

Export Houses, Trading Houses, Star Trading Houses and Super Star Trading Houses: The objective of the scheme is to recognize established exporters as Export House, Trading House, Star Trading House and Super Star Trading House for export promotion. Such houses should operate as highly professional and dynamic institutions and act as instruments of export growth. Merchant as well as manufacturer exporters, service providers, Export Oriented Units, Units located in Export Processing Zones/Special Economic Zones/Electronic Hardware Technology Parks/Software Technology Parks are eligible for such recognition.

The eligibility criterion for such recognition is based on the F.O.B./Net Foreign Exchange (NFE) value of export of goods and services, including direct software exports as well as based on the services provided during the preceding three years or the preceding licensing years, at the option of the exporters (Table-17.10).

Table-17.10
Export Obligation for Export/Trading Houses

Category	Average FOB value during the preceding three licensing years, in Rupees	FOB value during the preceding licensing year, in Rupees	Average NFE earned during the preceding three years, in Rupees	NFE earned in the preceding licensing year, in Rupees
Export House	15 Crore	22 Crore	12 Crore	18 Crore
Trading House	75 Crore	112 Crore	62 Crore	90 Crore
Star Trading House	375 Crore	560 Crore	213 Crore	450 Crore
Super Star Trading House	1125 Crore	1680 Crore	937 Crore	1350 Crore

Source : Exim Policy, 2001-2002

The policy proposed to recognize service exporters as granting recognition similar to manufacturer exporters (Table-17.11). Services include all the 161 tradable services covered under the General Agreement on Trade in Services where payment for such services is received in free foreign exchange.

Table-17.11
Export Obligation for Service Export Houses

Category	Average free foreign exchange earning during the preceding three licensing years	Free Foreign exchange earning in the preceding licensing years	Average NFE earned during preceding three licensing years	NFE earned during the preceding licensing year
Service Export House	Rs. 4 Crore	Rs. 6 Crore	Rs. 3 Crore	Rs. 5 Crore
International Service Export House	Rs. 20 Crore	Rs. 30 Crore	Rs. 15 Crore	Rs. 25 Crore
International Star Service Export House	Rs. 100 Crore	Rs. 150 Crore	Rs. 75 Crore	Rs. 125 Crore
International Super Star Service Export House	Rs. 300 Crore	Rs. 450 Crore	Rs. 225 Crore	Rs. 375 Crore

Source : Exim Policy, 2001-2002

The policy also proposed to promote Agriculture Export Zones. The objective is to provide remunerative returns to the farming community in a sustained manner by providing access to the products of agriculture and allied sectors in the international market. The responsibility of identifying product specific Agri Export Zone has been entrusted to state government. The units set up in the agri export zones are eligible for all concessions and benefits which a normal exporter is entitled to. The agri exporter is eligible for recognition at Export House/Trading House/Star Trading House/ Super Star Trading House based on export performance.

Another feature of the new exim policy is its objective to promote quality and national brands. The government, along with state governments will launch nationwide programmes on quality awareness and promote the concept of total quality management. A committee will be constituted to identify and promote branded products.

Bar coding has been mandatory for all finished and packaged items of exports. This is to comply with the prevalent best international practices. On the whole, the new Exim Policy while lifting remaining QRs on imports, proposed various measures to fundamentally promote India's export growth on a consistent basis.

Activity-A :

Go through the latest EXIM policy of our country and analyse it critically

17.7 SUMMARY

How far India's exim policy has contribute to the shaping up of foreign trade, is a debatable question. India pursued a restrictive trade policy till 1991 and in the process suffered in terms of competitiveness. The economic crisis of 1991 resulted in the adoption of a new strategy for exim policy and foreign trade. Consistent and steady liberalisation in the form of dismantling tariff and non-tariff barriers has become the hall mark of India's exim policy in the 90s. However, so far it has not succeeded either in bringing about any favourable structural change in India's exports or in accelerating the growth of exports to exceed imports and pay fully for the import bill.

The World Trade Organization (W.T.O) and its membership obligation has made India to completely lift the quantitative restrictions on imports with effect from 1st April 2001. This is anticipated to give a new direction to India's foreign trade in the new decade. Qualitatively superior but cheaper imports are likely to pour into Indian markets. Indian exports have to step up their quality and cost competitiveness to penetrate the interanational market successfully. Only quality and price will determine the rate of growth of Indian exports here after. Accordingly, the new Exim Policy has introduced various measures laying thrust on quality and brand promotion, development of infrastructure for export growth, and incentives for consistent export performers.

17.8 SELF-ASSESSMENT TEST

1. Analyse the merits and de-merits of foreign trade for a developing country. Examine whether it will be possible for an economy to grow by keeping itself aloof from the rest of the world in the current era ?

2. Describe the growth trends of India's exports and imports since 1950-51. Comment on India's trade balance position in the five decades of post-independence era.
3. Examine the implication of the changing composition of India's exports and imports in the 90s as compared to the earlier decades.
4. Comment on India's direction of trade during 1949/50 - 1998/99. Do you favour India's current trend of growing trade relationship with the Asian countries as compared to OECD countries? Why?
5. What role trade policy can play in the promotion of foreign trade of a country? What are the different kinds of trade policies? Analyse their merits and de-merits?
6. Examine the major features of India's Exim Policy during 1947-90. What was its impact on Indian foreign trade and economy?
7. "India's Trade Policy reforms adopted in the 90s are radical by any standards". Do you agree? Why?
8. Evaluate India's trade liberalisation in the context of India's trade performance in the 90s. Why trade liberalisation has not enabled India to achieve favourable balance of trade so far?
9. "W.T.O and removal of quantitative restrictions will totally transform the trade scenario of India". Will you agree? Discuss.

17.9 FURTHER READINGS

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UNIT - 18 : INDIA'S BALANCE OF PAYMENTS

Objectives

After going through this unit, you will be able to:

- Understand the basic concepts relating to balance of payments of a country ;
- Learn about major factors responsible for periodic foreign exchange crises experienced by India;
- Understand recent trends in trade and current account balance in India's balance of payments; and
- Learn about the factors behind trends in respect of balance of payments position.

Structure

- 18.1 Introduction
- 18.2 Balance of Payments-Basic Concepts
- 18.3 Factors Behind Recurring Foreign Exchange Crises in India
- 18.4 Recent Trends in India's BOP Position
- 18.5 Summary
- 18.6 Self-Assessment Test
- 18.7 Further Readings

18.1 INTRODUCTION

In the earlier unit, i.e. unit 17, you have learnt about India's foreign trade and the country's export and import policies. Because India has economic relations with other countries, Indian economy is referred to as an open economy. Although the degree of openness of the Indian economy is relatively small compared to some other countries, India as a developing country needs foreign trade and capital inflows for her economic development. The degree of openness is measured by country's export and import magnitudes. Exports as percentage of Gross National Product at factor cost at current prices in India worked out to 9.3 per cent in 1996-97. In the same year the imports as a percentage of GNP worked out to 10.9 percent.

Table-18.1
INDIA'S OVERALL BALANCE OF PAYMENTS

	1997-98		Rs. in Crores
	Credit	Debit	Net
	A. Current Account		
I. Merchandise	1,29,575.9	1,90,266.5	-60,750.9
II. Invisibles	85,517.9	49,321.2	36,195.9
Total Current Account (I+II)	2,15,033.0	2,39,558.0	-24,555.0
B. Capital Account			
1. Foreign Investment (net)	33,045.2	14,612.4	18,432.8
2. Loans (net)	64,110.7	46,688.5	17,422.2
3. Banking Capital	33,053.6	36,243.4	-3,189.8
4. Rupee Debt Service	---	2,783.5	-2,783.5
5. Other Capital Account Items	23,821.9	9,170.8	14,651.1
Total Capital Account (1+5)	1,54,031.4	1,09,498.6	44,532.8
C. Errors and Omissions	----	3,324.0	-3,324.0
D. Overall Balance (A+B+C)	3,69,064.4	3,52,410.6	16,653.8
E. Monetary movements (i+ii)	5,900.5	22,554.3	-16,654.3
1. IMF	----	2,286.2	-2,286.2
2. Foreign Exchange Reserves	5,900.5	20,268.1	-14,367.6
(increase(-), Decrease (+))			

* Invisibles include services, transfers and investment income.

Source : RBI, Report on Currency and Finance, 1997-98

The corresponding figures for the low income economies (LIEs) were 22.3 per cent and 22.1 per cent respectively (the World Bank in its World Development Report 1999/2000 classified the economies in the world into three categories namely, low income economies (LIEs), Middle-income economies (MIEs), and High-income economies (HIEs) on the basis of GNP per capita. The GNP per capita cutoff levels are as follows. (Low income \$760 or less in 1998, middle income - \$ 761 to \$ 9,360 and high income - \$ 9,361 and above). India is one of the Low-income countries. Broadly speaking thus India depends to a lesser extent on foreign trade than the LIEs. This is not to belittle the role of and the need for foreign trade in the Indian economic development. In this unit we learn different aspects relating to India's balance of payments.

18.2 BALANCE OF PAYMENTS - BASIC CONCEPTS

The balance of payments is the annual record of transactions of the residents of a country with the rest of the world. There are two main accounts (see Table 18.1) in the balance of payments. One is the current account and the other is the capital account. The current account consists of trade in goods (merchandise exports and imports), trade in invisibles which include

services such as travel, transportation and insurance, transfer payments and investment income. From Table 18.1 we note that in 1997-98, India's merchandise or commodity trade balance was Rs. (-) 60750.9 crores (deficit in trade account). The balance under invisibles was Rs. 36195.9 crores. Total current account balance was thus Rs. (-) 24555.00 crores. Trade deficit was partly offset by balance in invisibles. The current account balance in 1997-98 was negative indicating that our receipts under current account fell short of our payments under current account. In other words there was deficit in our current account.

The capital account records transactions involving investments and lending and borrowing internationally. From Table 18.1 you can see that the capital account in 1997-98 was in surplus. Thus there was net capital inflow into the country. The capital account surplus was more than the deficit in current account. The overall balance, taking into account current account balance, capital account balance and errors and omissions was positive amounting to Rs. 16653.8 crores. The surplus or deficit in overall balance is taken care of by monetary movements shown in Table 18.1. The overall balance of Rs. 16653.8 crores is exactly offset by the monetary movements. As can be seen from Table 18.1 in 1997-98 country could increase its foreign exchange reserves by Rs. 14367.6 crores. In general a country meets its deficit in BOP by running down its foreign exchange or official reserves. When a country runs balance of payments surplus, the country's foreign exchange reserves would increase. If you go through the Table 18.1 carefully and read the above explanation of the table you will get a thorough understanding of the BOP concepts. We turn to the factors responsible for persistent balance of payments problems India has been facing in the post - independence period after noting some more concepts.

We need to understand some more basic concepts of international trade and finance. One is the fixed exchange rate regime. In a fixed exchange rate system foreign central banks will be willing to buy and sell their currencies at a fixed price in terms of rupees. Under this Brettonwoods system of fixed exchange rates countries were willing to stick to the fixed exchange rates.

Central Banks hold reserves - inventories of foreign currencies and gold - in order to intervene in foreign exchange market to maintain fixed exchange rate. Intervention in foreign exchange markets is buying or selling of foreign exchange by the central bank as the situation needs. Here we may note the distinction between "hard" and "soft" currencies. Hard currencies are those which are generally widely accepted across countries in the settlement of transactions. Such currencies are usually referred to as reserve currencies because countries prefer to hold these currencies in their official foreign exchange reserves. Broadly speaking currencies like US Dollar, British Pound and German Mark are examples of hard currencies. Currencies of all the developing countries in Asia, Africa and Latin America are examples of soft currencies which are not generally accepted in international transactions. Under fixed exchange rate regime, central banks with the help of foreign exchange reserves were trying to maintain fixed exchange rates through market intervention. As long as a central bank has the necessary reserves, it can continue to intervene in the foreign exchange markets to keep the exchange rates constant. However, if deficits in balance of payments persist, the central bank may run out of reserves of foreign currencies and will be unable to continue its intervention. Before this crisis point is reached the central bank is likely to decide to devalue the currency as it can no longer maintain the exchange rate. For example, during the fixed exchange rate regime which prevailed till 1973, India had to devalue rupee twice, once in 1949 and for the second time in 1966. Persistent deficits in BOP warranted these devaluations of rupee. We noted above that devaluation of rupee took place twice, once in 1949 and later in 1966. Historically the two stand for two major epochs in international monetary arrangements in a manner of speaking. The first devaluation took place when the British pound sterling was the most important reserve currency and the second when the American dollar was ruling the roost.

In contrast to fixed exchange rate regime, under flexible or floating exchange rate regime, the central banks allow exchange rate to adjust to equate the supply of and demand for foreign currency. In a system of clean floating, central banks stand aside completely and allow exchange rates to be freely determined in the foreign exchange market. What is the implication of this? Since the central banks do not intervene in the foreign exchange markets in a clean floating regime, foreign exchange or official reserve transactions are zero. This implies the BOP is zero in a clean floating regime, the exchange rate adjusting to make the current account and capital account balances sum to zero.

In actual practice, however, the flexible exchange rate regime in force since 1973 has not been one of clean floating. The existing regime is called managed or dirty floating. Under the regime of managed floating, central banks intervene in foreign exchange market to influence exchange rates.

Under fixed exchange rates when the price of dollar in terms of rupees was increased, it means rupee was devalued. If the price of dollar in terms of rupees decreases the rupee is said to have experienced revaluation. The depreciation and appreciation terms are used under floating exchange rate regime. If the price of dollar increases in terms of rupee, the rupee is said to have depreciated. If the price of dollar decreases in terms of rupees, rupee experiences appreciation. Although the terms devaluation and revaluation are used under fixed exchange rate regime and the terms depreciation and appreciation are used under floating exchange rate regime, there is no economic difference. These terms indicate the direction in which an exchange rate moves.

Activity A

1. What is trade balance ? What is its significance ?

2. Explain the terms devaluation and depreciation ?

3. How is current account deficit is met by a country ?

18.3 FACTORS BEHIND RECURRING FOREIGN EXCHANGE CRISES IN INDIA

India has been facing recurring foreign exchange crises in the post-independence period. Prior to recent devaluation, the Indian rupee has gone through two major devaluations, which were mentioned above. Right now anyhow the world is on "managed" or "dirty" float of major currencies or a regime of flexible exchange rates. The exchange rate of the Indian rupee is under managed floating linked to a weighted composite of currencies of the main trading partners. What have been the factors behind the recurring foreign exchange crises in India?

The two factors which stand out as the most prominent causes of the foreign exchange crises in the past in India are :

1. Heavy industry strategy adopted by planners; and
2. Mother Nature upsetting the planner's arithmetic about the food and the primary commodity supplies.

So far as the first factor is concerned it is the result of our own economic strategy. We have deliberately and consciously accepted the trade-off involved. Perhaps our great grand children will appreciate the sensible heavy industry strategy we adopted in the long run economic interests of the country. So far as the second factor is concerned we cannot throw the entire blame on voice-less nature. We miserably failed in harnessing our abundant water resources in order to make our agriculture different from what it has been all along - a gamble in monsoons. Never is too late and the sooner we can formulate and implement an integrated national river water policy - as the most senior and well meaning engineers have been suggesting untiringly and with unflinching optimism, the better for the future of the country. The recent economic history of the erstwhile Soviet Union has demonstrated beyond any reasonable doubt the dangers involved in neglecting the food production and depending on other countries to augment food supplies. Let us not leave to chance and Providence things which human ingenuity can help.

Another factor assumed great importance in the early 1970's was the spectacular oil price hike engineered by the OPEC (dictated by self interest of the exporting countries, accepting the free enterprise and laissez faire logic with a vengeance to the chagrin of the oil-importing countries particularly oil-importing developed countries). If we take a brief look at the trends in the oil import bill, we will realise the importance of this third factor. In 1970-71 the oil-import bill amounted to a mere Rs. 136 crores. Thanks to the oil - price hikes, it shot up to Rs. 1157.1 crore and in early 1980's the figure hovered round Rs. 6,000 crores. Energy being an important input (there is virtually no activity which does not require some source of energy), the entire cost-structure of an economy is adversely affected by rise in energy prices. The oil - bill constituted about 50 per cent of our total import in the year 1980-81. This percentage was hardly 9 in the year 1970-71.

The fourth factor which has assumed considerable significance since the mid-70's is the adverse movements in terms of trade. Given the quantum of trade, adverse trends in terms create the payments problem. In this connection the close relationship between the above factor (oil price hikes) and the terms of trade movements should not be lost sight of. With 1968-69 as the base year the net terms of trade index recorded a steep fall between the early 1970's and early 1980's. The index fell from 106 in 1970-71 to 66 in the year 1979-80.

The fifth factor to be noted in this connection is the deteriorating world trade and credit situation in general in recent years. The immediate cause of the loss of reserves beginning in September 1990 was a sharp rise in the imports of oil and refined products (POL). From an average of Rs. 499 crores per month in June - August 1990, POL imports rose sharply to Rs. 1221 crores per month in the following six months. There was a sharp rise in world oil prices on

the annexation of Kuwait, and spot purchases made to prevent the emergence of shortages in the domestic market were very costly. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be air lifted back to India, and their remittance ceased to flow. Further, the consequent UN trade embargo on Iran led to the cessation of exports to Iran and Kuwait. The loss of exports to West Asia is estimated to have been about Rs. 500 crores. This deterioration in the trade account was accompanied by the other adverse developments on the capital account reflecting the loss of confidence in the government's ability to manage the situation. Short term credits began to dry up imposing a severe strain on the BOP position. We take up recent trends in BOP in the next section.

Activity B

1. State and explain two major factors responsible for recurring foreign exchange crises in India.

2. Explain how petroleum price hikes engineered by OPEC had adverse effect on India's BOP.

18.4 RECENT TRENDS IN INDIA'S BOP POSITION

During the pre-reform period from 1973-74 through 1989-90 the current account balance in India's BOP was negative except during the few years. The current account deficits however, were not as bad as trade deficits during the period because of better showing in respect of invisibles. The current account deficit reached the all time high during the year 1990-91 (Rupees 17368.5 crores). The following table gives the current account balance for the post-reform period including data for two earlier years.

Table - 18.2
Recent Trends in Current Account Balance

Year	Current Account Balance	
	Rs. in Crores	US \$ Million
1990-91	(-) 17,368.5	(-) 9680
1991-92	(-) 2,237.3	(-) 1178
1992-93	(-) 12,763.5	(-) 3526
1993-94	(-) 3,635.8	(-) 1158
1994-95	(-) 10,582.6	(-) 3369
1995-96	(-) 19,606.7	(-) 5899
1996-97	(-) 115,839.1	(-) 4494
1997-98	(-) 24,555.0	(-) 6473

Source : RBI, Report on Currency and Finance, different years.

Except during 1991-92 and 1993-94, the current account showed substantial deficit. The deficit fluctuated during the post-reform period reaching Rs. 24555.0 crores during the year 1997-98.

The unprecedented payments crisis which emerged in the first quarter of 1991-92 was overcome by the concerted policy reforms initiated by the government in July 1991. As a result of this policy reforms and successful mobilization of exceptional financing, there was marked improvement in the external payments situation. This was reflected in the building up of foreign exchange reserves by an additional amount of US \$ 3.57 billion during 1991-92. Table 18.3 gives the data relating to actual and required reserves during the period 1990-91 to 1997-98.

The increase in reserves compound with stabilization and structural reforms restored international confidence and also provided the basis for further liberalization of trade traffics, export, crudity and foreign investment policies during 1992-93. As a result of a package of liberalization measures, foreign currency assets which have plummeted to US dollar 1.1 billion in June 1991 gradually rose as can be seen from Table 18.3

Table - 18.3
Foreign Exchange Reserves

(Rs. in Crores)

Year	Actual Reserves		Imports	Required Reserves
	in Million US\$	Rs. in Crores		
1990-91	2236	4388.1	43198	10799.5
1991-92	5631	14578.0	47851	11962.0
1992-93	6434	20140.5	63375	15843.8
1993-94	15068	47287.3	73101	18275.3
1994-95	20809	665.6	89971	22492.8
1995-96	17044	58445.9	122678	30669.5
1996-97	22367	80367.5	138920	34730.0
1997-98	25975	102506.7	151553	37888.8

Note : Required reserves are equal to minimum foreign exchange reserve level equal to three-months import bill.

Source : RBI, Report on Currency and Finance, different years.

The year 1993-94 saw a remarkable turn around in India's external sector. Foreign currency assets of the RBI more than doubled during the year, increasing from US dollar 6.4 billion at the end of March 1993 to US dollar 15.1 billion to the end of March 1994. The large buildup of reserves was due to a marked improvement in the current account and increase in private capital flows on the capital account. Exports responded to reforms in trade and BOP policies in 1993-94 taking export growth up to 20 per cent in dollar terms. The surplus on the invisibles account doubled. The current account deficit came down from Rs. 12763.3 crores during the 1992-93 to Rs. 3635.8 crores during 1993-94. The capital account was bolstered by sharp increases in direct foreign investment and portfolio investment which rose from less than \$ 600 million in 1992-93 to over 4 billion in 1993-94.

The balance of payment position has been further consolidated in 1994-95. The build up in foreign currency reserves continued and reached a level of \$ 20.9 billion during 1994-95. This build up was despite a sharp pick up in non-oil import growth and was a result, predominately, of continuing strong inflows of non-debt creating capital. The outstanding external debt declined marginally from \$ 90.7 billion at the end of March 1994 to \$ 90.4 billion at the end of September 1994. The continued strength in the balance of payments underpin the country's successful transition to current account convertibility.

The trade and payments position remained reasonably comfortable during 1995-96. For the third year in succession, export growth was robust, supported by a congenial domestic policy environment. Import growth was also high, reflecting the continued good performance of the industrial sector.

The developments in India's trade and payments over the period 1991-92 to 1995-96 mark a noticeable structural change towards a more stable and sustainable balance of payments. During the post - liberalization period, there has been a sharp improvement in the coverage of import payments through export earnings. The coverage ratio averaged to about 88 percent since 1992-93 compared with only 52.4 per cent at the beginning of the 1990's and about 70

percent at the end of 1980's. There has also been a marked improvement in the flow of invisible receipts. Together these changes brought about a sharp reduction in the ratio of the current account deficit to GDP, from an unsustainable level of 3.2 per cent in 1990-91 to 1.6 per cent in 1997-98. There has been a structural change in the capital account in terms of a sharp reduction in debt creating flows and an increase in non-debt creating foreign investment flows. For example, debt creating flows as percentage of total capital inflows in the balance of payments average to 97 per cent during the period 1985-86 to 1989-90. But the ratio declined very sharply to less than 18 per cent in 1994-95. This favourable shift away from recourse to debt creating flows for financing the current account deficit, has obvious implications for moderating and reducing further debt service liabilities.

The trends in current account deficits got themselves reflected in growing external debt serving burden. During the pre-reform period the current account deficit reached a high of Rs. 17368.5 crores (Table 18.2). India's external debt outstanding increased from Rs. 13479.3 crores in 1980-81 to staggering amount of Rs. 100425 crores in 1990-91. Table-18.4 gives recent trends in India's external debt. It rose from Rs. 232268 crores in 1991-92 to Rs. 351245 crores in 1997-98. Thanks to improvement in trade performance and better showing in respect of invisibles there has been a steady decline in debt service payments as per cent of current receipts. The percentage during the reform period declined from 27.5% in 1992-93 to 19.5 per cent in 1997-98.

Table 18.4
INDIA'S EXTERNAL DEBT
(Rs. in Crores)

Year (end of March)	Debt	Debt Service Payment as Percent of Current Receipts
1991-92	232268	30.2
1992-93	260942	27.5
1993-94	279043	25.6
1994-95	298237	26.2
1995-96	304091	24.3
1996-97	311674	21.2
1997-98	351245	19.5

Source : RBI, Report on Currency and Finance, different years.

Global Financial markets have come under unprecedented tensions as a fall out of the crisis that erupted in East Asia in July 1997. India's balance of payments withstood fairly well the turbulence in the international economic and financial markets. In fact, the balance of payments in 1997-98 remained comfortable with substantial reserve accumulation supported by strong private capital flows. As noted before, export growth slowed down sharply over the last three years because of both international and domestic factors. The economy is yet to recover from recent recessionary trends. The recent (1999) political instability is a cause for concern so far as performance of the economy in the coming years is concerned.

Export performance is an important determinant of a country's BOP position. If we begin the story of export performance with 1970's export growth rate in real terms (nominal growth rate corrected for changes in the index of unit value of exports) averaged to an annual rate of 8.4 per cent during the period 1971-72 to 1991-92.

Export Sector performed extremely well in the four - year period from 1986-87 to 1989-90 when exports grew at an average annual rate of more than 21 per cent in nominal terms. The momentum however was lost in 1990-91 when export growth decelerated to 17.7 per cent. Conditions worsened further in 1991-92 as the full effect of import compression began to be felt in industrial sector. The growth rate of exports in US dollar terms turned negative and stood at (-) 1.5 percent. This deceleration was caused by a number of factors such as slow down in the expansion of world trade, recession in the major industrial economies, loss of markets in the middle East consequent to the gulf crisis and a virtual collapse of exports to erstwhile Soviet Union. Exports began to recover during 1992-93. During the year exports in US dollar terms registered modest growth rate of 3.8 per cent. In the following three years export growth rate accelerated. As part of the process of increasing global integration, India's exports in dollar terms, after growing by 20 per cent and 18.4 per cent in the two previous years (1993-94 and 1994-95) grew by a further 20.8 per cent in 1995-96. During the subsequent two years export growth decelerated. Growth rate declined to 5.3 per cent in 1996-97. During the subsequent year 1997-98 growth rate turned negative and stood at (-) 0.8 per cent.

The slow down in export growth since 1996-97 must be viewed in the backdrop of external developments and slow down of domestic industrial activity. The rate of growth of world exports (in US dollars), decelerated in 1996 to 3.7 per cent following two years of high growth (19.8 per cent in 1995 and 13.7 per cent in 1994).

Slowdown of economic growth in USA and Japan (two largest export destinations) is also a factor to be noted in this connection. The growth rate of imports of advanced economies declined from 13.4 per cent in 1994 and 18.2 per cent in 1995 to 3.6 per cent in 1996. Imports of USA and Japan, our two largest export destinations grew only by 8.6 per cent and 4.0 per cent respectively in 1995 and 1996.

In 1994, the rupee's appreciation in real terms, against the currencies of country's major trading partners and the failure of the world import growth to recover contributed to lack of recovery in export growth. The unprecedented depreciation of the currencies of our competitor countries in South East Asia like the Philippines, Indonesia and Thailand, was an additional factor in the second half of 1997-98. Infrastructure constraints, high transaction costs and quantitative ceiling on agricultural exports remain problematic though power supply growth recovered after a marked slowdown.

Some commodity specific factors also contributed to the decline in export growth. They are:

- (1) Environmental concerns regarding leather effluents and prawn farming
- (2) Non-availability of good quality rough gem stones, breaking of single channel supplies, growing competition and consequent uncertainty in non-cut diamond prices
- (3) A shift in the pattern of Western consumer demand for textiles and leather accessories and
- (4) Labor issues related to production of carpets.

As economic development of a country proceeds, structural changes in exports sector take place. Change take place in the composition of merchandise exports. Indian exports are broadly classified into four categories.

They are :

- (1) Agriculture and allied products
- (2) Ores and minerals
- (3) Manufactured goods and

(4) Petroleum and crude products.

Traditional exports dependent on agricultural and mineral wealth accounted for 42.4 per cent of total exports in 1970-71. Their share came down to 22 per cent by 1997-98. The share of manufactured goods in total exports was 50.3 per cent in 1970-71. This share went up to 74.8 per cent in 1997-98. The share of petroleum and crude products went up from 0.8 per cent in 1970-71 to 1.0 per cent in 1997-98. Obviously, the structure of Indian exports has been changing in favour of manufactured goods and petroleum products whose combined share went up from 51.1 per cent in 1970-71 to 75.8% in 1997-98.

Activity C

1. Explain the recent setback in respect of export growth

2. What are invisibles in BOP?

BRAOU

18.5 SUMMARY

In this unit, you are acquainted with the basic concepts relating to balance of payments of a country. You are also introduced to major factors responsible for periodic foreign exchange crisis faced by the Indian economy during the post-independence period. Finally we have given a detailed account of recent trends in India's balance of payments.

18.6 SELF - ASSESSMENT TEST

1. Explain the current and capital accounts of the balance of payments.
2. List and explain the major factors responsible for balance of payments problems in India.

18.7 FURTHER READINGS

1. Raddar Dutt and K.P.M Sundaram, Indian Economy, latest edition
2. V. Lakshmana Rao, Essays on Indian Economy, New Delhi; Ashish Publishing House, 1994, Essay 9
3. Reserve Bank of India, Report on Currency and Finance, different years.
4. Government of India, Economic Survey, recent years.

UNIT-19 : FOREIGN CAPITAL AND COLLABORATIONS

Objectives

This unit enables you to understand:

- What is foreign investment?
- What is a technical collaboration?
- Merits and demerits of promoting foreign investment and collaborations in a developing country?
- An overview of changing phases of India's foreign investment policy.
- Major features of India's restrictive foreign investment policy (1948-90)
- Trends in foreign investment and collaborations in India during 1948-90
- India's current foreign investment policy
- Dimensions of growing foreign investment and collaborations in India in the 90s.

Structure

- 19.1 Introduction
- 19.2 Foreign Capital : Arguments For and Against
- 19.3 India's Foreign Investment Policy: A Backdrop
- 19.4 India's Foreign Investment Policy (1948-90): Origin and Growth
- 19.5 Foreign Capital & Collaborations in India (1948-90): A Review of Trends and Its Impact
- 19.6 India's Foreign Investment Policy in the 90s
- 19.7 Foreign Capital & Collaborations : 1991-99
- 19.8 Summary
- 19.9 Self-Assessment Test
- 19.10 Further Readings

19.1 INTRODUCTION

Foreign capital or foreign investment refers to investment capital that may come into a country from foreign governments, foreign private companies, foreign individual investors, non-resident Indians (NRIs), or international financial institutions. Foreign capital or foreign investment may flow in for joint ventures with a domestic enterprise/s or for wholly owned subsidiaries, in industry, infrastructure or, service sector.

Foreign collaborations refers to foreign technological collaborations entered by domestic enterprise/s with foreign enterprise/s for the purpose of acquiring superior technology. Foreign collaborations will be largely confined to industry and infrastructure sectors.

Both foreign capital and foreign technical collaborations are controlled through Government Industrial Policies, particularly in developing countries. Though foreign capital and collaborations are advocated as a means of accelerating economic development, their efficacy varies from country to country.

19.2 FOREIGN CAPITAL : ARGUMENTS FOR AND AGAINST

Foreign capital is advocated for developing countries for the following reasons. The first and the most often cited argument in favour of foreign capital is that it fills the resource gap between targeted or desired investment and locally mobilized savings.

Secondly, it contributes to filling the gap between targeted foreign exchange requirements and those derived from net export earnings plus net public foreign aid, i.e. the so called foreign exchange gap.

Thirdly foreign capital enables the Government to raise tax revenues and thus bridge the gap between targeted governmental tax revenues and locally raised taxes. By taxing the profits of foreign enterprises operating in the country, the Government will be able to mobilise more financial resources for development projects.

Finally, there is a shortage of management, entrepreneurship, technology, and skills in developing countries. The inflow of foreign capital and operation of foreign enterprises will contribute to the development of all these, over a period of time, through the transfer of knowledge, managerial and labour skills and technology.

However, there are some arguments advanced against foreign capital. Though foreign capital is presumed to contribute to the resource gap, it may lower domestic savings and investment rates by stifling their profits, preventing the expansion of local enterprises who might otherwise supply them with intermediate products, by their practice of importing these goods from overseas affiliates, etc.

Further, in reality, foreign capital may not contribute to the foreign exchange gap in the medium to long run, due to their imports of raw materials and intermediates and repatriation of profits to their home country.

The management, entrepreneurial skills, technology and overseas marketing network of foreign enterprises may have little impact on developing countries and may, in fact, prevent the growth of indigenous entrepreneurship as a result of its dominance and control over domestic markets.

Some times, foreign capital inflow may result in the production of inappropriate products, stimulate inappropriate consumption patterns through advertising, and promote inappropriate capital intensive, production technologies. Finally, foreign capital may use its economic power to influence government policies in directions favourable to them but unfavourable economic development of the country in which it operates.

However, despite all short comings, developing countries in general, look for foreign capital/ investment as a means of augmenting investment, generating more employment, acquiring superior technology and penetrating the international market. To use foreign capital and collaborations to its own advantage, almost every developing country including India, has evolved its own foreign investment policy.

19.3 INDIA'S FOREIGN INVESTMENT POLICY : A BACKDROP

India's attitude towards foreign investment was largely influenced by its colonial past. India adopted a restrictive approach towards foreign investment, after independence. Though India welcomed the participation of foreign capital (through Industrial Policy Resolution in 1948), in the industrialisation process of the country, the deteriorating balance of payments position in the early 60s prompted the country to adopt a stringent approach for foreign investment. The enactment of Foreign Exchange Regulation Act in 1973 resulted in the emergence of a further barricade for foreign capital and collaborations. The 70s turned out to be the most restrictive period for foreign capital in India.

In the 80s, the process of liberalisation was begun, with the objective of attracting state-of-the-art foreign technology, particularly in core industries. However, it was with the onset of economic reforms in 1991 that foreign investment policy was liberalised substantially. The entry conditions and equity restrictions were given almost a go by, performance requirements have been confined to a few consumer industries and exit has been made easier.

Today, India's foreign investment policy can be compared favourably with any other liberal foreign investment policy in the developing world. Different states of the country compete with one another to attract more foreign capital through the assurance of quick state level clearance, infrastructural support, incentives and concessions, etc. Thus, the perception, attitude and approach of India's Policy Makers towards foreign capital and collaborations have undergone a remarkable change in the 90s. The dissuading restrictions due to apprehensions of exploitation have given way to affirmed invitation due to renewed optimism of gainful contributions to technology, infrastructure and overall competitiveness of the economy.

19.4 INDIA'S FOREIGN INVESTMENT POLICY (1948-90): ORIGIN AND GROWTH

India's foreign investment policy forms an integral part of its industrial policy. Therefore, the origin of foreign investment policy can be traced to the Industrial Policy Resolution (IPR) of 1948. The IPR, 1948 recognised the contribution that foreign investment could make, particularly in terms of technology to India's industrialisation but emphasised that the ownership and control of enterprises involving foreign equity must lay in Indian hands. This represented the first broad framework towards foreign investment.

Soon thereafter, the then Prime Minister of India made a statement in the Constituent Assembly (in April 1949) on foreign investment which gave further direction to India's emerging foreign investment policy. The statement brought out three significant issues : (i) No discrimination between India and foreign enterprises, (ii) Foreign investors would be allowed to remit profits, and repatriate capital if foreign exchange position permits, and (iii) Fair compensation would be provided in the event of nationalisation.

This statement ensured the safety of foreign investors and it became the base of India's foreign investment policy subsequently, for almost two decades. Government encouraged foreign collaborations in those industries : (1) which were considered essential for the country's development, (2) which required huge capital outlay and complex technology, and (3) which helped to produce import substituting and export oriented products. During this period, foreign collaboration with equity participation was encouraged with the anticipation that it would facilitate superior technology inflow and ease foreign exchange constraint. On the whole, during this period Government pursued a selective but favourable approach towards foreign direct investment.

Entry conditions and equity restrictions formed the corner stones of India's foreign investment policy : (1) Entry was encouraged mainly in high tech industries and (2) Equity up to 49 percent only was allowed. The objective was to ensure that foreign enterprises contribute to India's industrial development, without any negative impact.

In 1966, the Government formed the Mudaliar Committee to probe the extent to which foreign technology could be dispensed with and to frame guidelines for processing application for foreign collaborations. The Committee among others, recommended (1967) a liberal approach in case of export oriented industries and favoured joint ventures in industries where foreign collaboration is allowed, which involved import of capital goods. This marked the beginning of a restrictive regime for foreign investment.

In December 1968, the Foreign Investment Board was set up. The Board was empowered to deal with all matters relating to private foreign investment and collaborations where foreign investment did not exceed: (i) Rs. 2 million of equity capital and (ii) 40 percent of issued capital. In cases exceeding these limits, the clearance of the Cabinet Committee was required.

In January 1969, the Government divided the industrial sector into three groups for purposes of foreign investment: (1) The industries where foreign investment would be permitted, (2) The industries where only foreign technical collaborations were allowed but not foreign investment, (3) The industries where no foreign collaboration, financial or technical, was allowed. In the first two categories, the permissible limit of royalty for different items was fixed at 5 percent. The duration limit for foreign collaborations was reduced from 10 to 5 years and their renewals were restricted.

Foreign collaboration in industries, which were not included in any of the three lists mentioned above, was considered on merit. The lists were revised continuously to narrow down the area permissible for foreign collaborations. By 1973, the number of industries where foreign investment was permitted has come down to 19.

The Industrial Policy Statement of 1973 further sought to restrict the operations of foreign enterprises to a select group of core industries. This was followed by the enactment of the Foreign Exchange Regulation Act (FERA) 1973. FERA became the corner stone of the regulatory framework for foreign investment in the subsequent years. FERA covered all non-banking branches and companies incorporated under the Indian Companies Act, 1956 with more than 40 percent foreign equity participation. All such companies were required to obtain permission from the Reserve Bank of India (R.B.I) to continue business.

The permission was subject to the Indianisation or dilution of foreign equity down to 40 percent. Companies operating in the core sector, tea plantations and those engaged in manufacturing activities based on sophisticated technology or predominantly producing for exports were, however, permitted to retain up to 51 percent/ 74 percent equity.

FERA forced foreign enterprises either to curtail their equity participation to 40 percent or less or leave the country. FERA emerged as a hindrance or discouraging factor for the entry of new foreign enterprises. The restrictive regime for foreign investment was in full force till the late 70s.

By the end of 1970s, India realised that the competitiveness of Indian goods in the international market had suffered due to technological obsolescence, inferior product quality and high cost. This was attributed among others, to protection given to Indian producers from internal as well as external competition. To improve the competitiveness of Indian industry, the role of foreign investment and technology was recognised as crucial. As a first step, the Industrial Policy Statements of 1980 and 1982 liberalised licensing rules, and exempted 100% Export Oriented Units (EOUs) from foreign equity restrictions under FERA. Thereafter, attitude towards foreign investment started becoming favourable. Foreign equity even in existing Indian Companies

was permitted, provided that involved inflow of superior technology. Direct application by a foreign investor even before choosing an Indian partner was made possible. A fast channel for speedy clearance was set up to attract increasing foreign investments from industrialised countries such as Japan, U.S.A, U.K. and France. Tax rates on royalties were reduced, and procedures for outward remittances of royalties, technical fees, and dividends were streamlined. Thus, India's foreign investment policy, which took a definite but restrictive shape in the early 70s turned relatively liberal in the 80s. This, among others has an influence on the trends and growth of foreign investment in India prior to the 90s.

19.5 FOREIGN CAPITAL & COLLABORATIONS IN INDIA (1948-90) : A REVIEW OF TRENDS AND ITS IMPACT

At the time of independence, India looked at foreign capital as a source of superior technology for industrialisation and economic development. With that objective, foreign capital was encouraged mainly in high-tech industries/industries which produce import substituting/export oriented products. Thus, foreign capital was considered a means of achieving economic self-reliance. In order to ensure that enterprises involving foreign investment serve Indian economic interests, foreign equity participation was allowed only up to 49 percent i.e. to ensure that ownership and control remain with Indian hands. But no major effort was made to alter the already existing composition of foreign investment. At this stage, India's foreign investment policy was clearly at its infancy.

Till the mid-50s, the number of foreign collaborations approved was not all that significant. But in the subsequent decade, there was a spurt in foreign collaboration approvals (Table-19.1). This could be due to among others, heavy industries' based industrialisation strategy adopted by the country in the second five year plan and pursued in the third plan.

Table - 19.1

Foreign Collaboration Approvals (1948-90)	
Period	Total No. of Collaboration Approvals
1948-55	284
1956-61	1199
1962-67	1624
1968-73	1215
1974-79	1748
1980-85	3956
1986-90	4007

Source : Government of India: Foreign Collaborations, 1995, Department of Scientific and Industrial Research, Ministry of Science and Technology, New Delhi.

A sectoral composition of foreign investment stock reveals that bulk of it was concentrated in plantations and petroleum (44%) whereas mining, manufacturing and services accounted for the rest (Table-19.2). This could be explained in different ways. Prior to independence, India was mainly used as a source of raw materials for British Companies. The underdeveloped industry and infrastructure and the availability of vast natural resources encouraged foreign enterprises to exploit the latter. This is evident if we add the stock of foreign investment in agro

based industries (food and beverages, textile products) with that of petroleum and plantations : they together accounted for almost two-thirds of the stock of foreign investment in 1964.

Table - 19.2
Sectoral Distribution of the Stock of FDI in India, 1964-1990

(Rs. Million)

Industry Group	March Value	1964 %	March Value	1974 %	March Value	1980 %	March Value	1990 %
I. Plantations	1059	18.7	1072	11.7	385	4.1	2560	9.5
II. Mining	47	0.9	64	0.8	78	0.8	80	0.3
III. Petroleum	1433	25.3	1379	14.7	368	3.9	30	0.1
IV. Manufacturing	2293	40.5	6256	68.4	8116	86.9	22980	84.9
1. Food and Beverages	302	13.2	521	8.3	391	4.8	1620	7.0
2. Textile Products	166	7.2	356	5.7	320	3.9	920	4.0
3. Machinery & Machien Tools	157	6.8	421	6.7	710	8.8	3540	15.4
4. Transport Equipment	150	6.5	321	5.1	515	6.3	2820	12.23
5. Metal & Allied Products	331	14.4	867	13.9	1187	14.6	1410	6.1
6. Electrical Goods	182	7.9	681	10.9	975	12.0	2950	12.8
7. Chemical & Allied Products	601	26.2	2037	32.6	3018	37.2	7690	33.4
a. Chemicals	163	7.1	760	12.2	1306	16.1	NA	NA
b. Medicines & Pharmaceuticals	232	10.9	697	11.1	1057	13.0	NA	NA
c. Others	206	8.9	581	9.3	655	8.1	NA	NA
8. Miscellaneous	404	17.6	1050	16.7	1000	12.3	2030	8.8
v. Services	823	14.6	398	4.4	385	4.1	1400	5.2
TOTAL	5655	100.0	9169	100.0	9332	100.0	27050	100.0

Source : Kumar, N: *Multinational Enterprises and Industrial Organisation : The Case of India*, 1994, p-41

A comparative picture for India and the rest of the world revealed that the stock of foreign capital in India accounted for hardly 11 percent of the stock in Asia, less than 3% of the stock in the developing world and hardly 1% of the stock in the entire world in 1967 (Table - 19.3). And empirical studies based on the data up to 1965-66 have brought out that costs due to private foreign investment in India exceeded the economic benefits flowed from their operations, implying that foreign capital did not play any conducive role in the initial stage of India's development.

Table - 19.3

**Stock of Foreign Direct Investment - India, Asia, Developing Countries
and the World**

Country / Region	1967	1973	1980	1990
I. India*	0.9	1.2	1.2	1.6
II. Asia	8.3	15.3	34.9	121
III. Developing Countries	32.3	54.7	110.3	293
IV. World	105.5	208.1	513.7	1442
I as % of II	10.84	7.8	3.4	1.3
I as % of III	2.79	2.2	1.1	0.6
I as % of IV	0.85	0.6	0.2	0.1

* Converted into U.S. dollars at the official exchange rate of the particular year.

- Sources :
1. Dunning, J.H. *Multinational Enterprises and the Global Economy*, 1992.
 2. *World Investment Report*, 1992
 3. *R.B.I. Bulletins*.

It was the Mudaliar Committee (1967) which marked the beginning of a restrictive phase in India's foreign investment policy. But there was hardly any evidence to show that it was based on the assessment of overall performance of foreign enterprises. Rather it was the difficult Balance of Payments (B.O.P) position in the late 60s and the need to conserve foreign exchange reserves which prompted the Government to go for a restrictive regime for foreign capital & collaborations. The sharp rise in outflow of foreign exchange on account of remittances of profits and dividends, royalties, technical fees and interest payments, which formed a significant proportion of the foreign exchange reserves of the country led the Government to adopt a more restrictive attitude.

Subsequent to the Mudaliar Committee's recommendations, the number of industries where foreign capital investment permitted was continuously pruned. The general ceiling of 40% for foreign equity participation followed by FERA, 1973 further restricted the entry of foreign capital. The number of foreign collaborations approved declined (see Table-19.1). It was during this period that a change in the sectoral composition of foreign investment stock began (see Table-19.2). Though foreign investment stock increased considerably, it was by and large confined to the manufacturing sector, as a result of which the relative share of the sector went up from 40 percent in 1964 to 68 percent in 1974.

But despite policy becoming restrictive, the outflow of foreign exchange through remittances increased in the early 70s as compared to 60s. This could be because, apart from narrowing down the area and scope for foreign investment, no specific policy measure was introduced during 1967-73 in terms of operational/performance requirement or incentives to obtain net positive contribution from foreign enterprises. And despite an increase in foreign investment stock, India's share in the foreign investment stock of Asia/developing countries/world declined considerably (Table-19.3).

But the real transformation in the sectoral composition of foreign investment stock in India took place after FERA came into being in 1974. Foreign enterprises not willing to reduce the foreign equity to 40 percent were forced to quit such enterprises were nationalised. This

was largely confined to petroleum and plantations. But, foreign collaborations in the manufacturing sector continued to grow (Table-19.1). As a result, though foreign investment stock increased only marginally (1974-80), the relative share of manufacturing sector, particularly, chemicals, electrical goods, machinery & machine tools and metal products increased substantially accounting for almost three-fourths of the foreign investment stock by 1980 (see Table-19.2).

It was this FERA era in the 70s that virtually placed India out of the global investment scenario. India's foreign investment stock accounted for hardly 4 percent of that of Asia, about 1 percent of that of the developing world and a mere 0.2 percent of the total global foreign investment stock (Table-19.3).

In the early 80s it was realised that foreign investment and technology have a crucial role to play in enhancing India's industrial competitiveness in the international market. Towards that end, foreign investment and technology inflow had to be facilitated rather than restricted. Accordingly, Export Oriented Units (EOUs) were exempted from FERA, foreign equity in existing companies permitted, if it involved inflow of superior technology, fast track channels for FDI from industrialised countries set up, outward remittance of royalties, technical fees, and dividends made easier, etc.

There was a sharp increase in the number of foreign collaborations approved in the 80s (Table-19.1). There was almost a three-fold increase in the rupee value of India's foreign investment stock during 1980-90 (Table-19.2). But this was not in proportion to the increase in global trends (in dollar terms). As a result, India's relative position declined further (Table-19.3). The reasons are not far to seek. While restrictive conditions could effectively shut the door to foreign investments and collaboration, liberalisation may not always be followed by an instantaneous upsurge of foreign enterprises' interest in a developing country. This will be so, particularly when liberalisation is selective.

On the whole, during 1948-90, India's foreign investment policy was evolved mainly with the objective of enabling inflow of superior technology for industrial development. But to ensure that foreign capital inflow does not strain the country's foreign exchange reserves, the policy consistently reduced the scope for foreign investment in terms of equity and activities, since the late 60s. Though India resorted to selective liberalisation in the 80s to provide a greater role for foreign investment and technology in order to promote exports and improve industry competitiveness, it hardly succeeded in preventing the deteriorating position of India as the investment destination for foreign enterprises.

The liberalisation implemented in the 80s could not alter/bring down substantially the general barricade erected in the form of entry and equity restrictions for foreign capital through FERA. Consequently, India was further marginalised globally in terms of foreign capital inflows. In brief, India's foreign investment policy during 1948-90 achieved little in terms of its primary objectives: infusion of technological dynamism into industry and augmenting India's investible resources.

19.6 INDIA'S FOREIGN INVESTMENT POLICY IN THE 90S

India's economic crisis of 1991 forced the country to go for a programme of macroeconomic stabilisation and structural reforms. The structural reforms were initiated with the introduction of a new Industrial Policy in July 1991. Industrial delicensing, curtailing the role of public sector, removal of threshold limits on the asset size of large firms, provision of scope for merger and acquisition of firms, among others, formed the hallmarks of India's industrial policy reforms. The objective being the promotion of a more efficient and competitive industrial economy, along with industrial policy reforms, steps were also taken to facilitate the inflow of foreign capital.

Accordingly, to provide a larger role for foreign investment, FERA, 1973 was liberalised substantially and Foreign Exchange Regulation (Amendment) Act, 1993 was brought into force. A Foreign Investment Promotion Board (FIPB) was established to expedite the clearance of foreign investment proposals. India became a member of Multilateral Investment Guarantee Agency (MIGA) and thereby ensured protection to foreign investments. Since then India's foreign investment policy has undergone remarkable transformation.

India's present foreign investment policy can be briefly described as follows :

1. Foreign investment is allowed virtually in every sector of the economy except those of strategic concern such as defence and atomic energy.
 2. Foreign investment need not be accompanied by foreign technology.
 3. Foreign enterprises can use their own trademarks and brand names.
 4. Foreign investors can set up fully owned subsidiaries. Even if the equity investment is less than 100 percent, foreign investors need not have a local partner. The portion of equity not held by a foreign investor can be offered to the Indian public for subscription.
 5. A three-tier structure has been formed for the approval of foreign investment proposals.
 - * Automatic approval is granted in high priority industries by the Reserve Bank of India (RBI).
 - Up to 74 percent in nine industry groups
 - Up to 51 percent in thirteen groups of industries
 - Up to 50 percent in three industries in mining
 - * Approval for foreign investment proposals in the remaining industries is granted by the Secretariat of Industrial Assistance (SIA), Department of Industrial Policy and Promotion, Ministry of Industry, Government of India.
 - Foreign investment in a small industrial unit is permissible up to 24 percent of equity.
 - * Foreign Investment Promotion Board (FIPB) : A specially created body to accelerate the inflow of FDI. It will consider any foreign investment proposal irrespective of industries and size of investments.
 - Special packages are offered to key sectors where 100 percent equity ownership is possible: power, petroleum, roads and highways (under Build, Operate and Transfer basis), tourism, Export Processing Zones (EPZs), Export Oriented Units.
1. Existing foreign enterprises can raise foreign equity beyond 40 percent.
 2. In 22 groups of consumer goods industries, foreign investors have to adhere to dividend balancing for a period of seven years from the date of commencement of commercial production. Dividend balancing refers to the process of equating outflow of foreign exchange due to dividend repatriation by inflow of foreign exchange due to export earnings (see Annexure).

Thus, in the 90s India's foreign investment policy has been liberalised radically, particularly in terms of entry conditions and equity restrictions. (For major highlights of India's foreign investment policy in different periods of time, refer Box). As a result, foreign capital like domestic private investment can flow into any sector.

Box-19.1

India's Foreign Investment Policy (1948-99) : At A Glance

Period	I Entry Conditions	II Equity Restrictions	III Performance Requirements	IV Incentives	V Exit Conditions
1948-67	Encouraged mainly High tech industries	Equity participation upto 49% allowed	Nothing in clear terms. Anticipated to bring superior technology	Allowed to remit profits & rapatriated capital, if foreign exchange position permits	Fair compensation, in the event of nationalisation
1968-73	Three groups of industries 1. Foreign investment permitted 2. Foreign Technical collaboration permitted but not foreign investment 3.F.C. not allowed	40% general ceiling	---	- do -	Fair compensation, in the event of nationalisation
1974-79	FERA formed the guiding factor or investment policy, FI* allowed only in 19 industries Foreign Investment cleared by RBI	40% general limit. High-tech and export oriented industries exempted	Foreign investment to be accompanied by Foreign Technology. Remittance of dividends require RBI permission under FERA	Nothing Significant	Units not willing to reduce equity to 40% were forced to quit. Repatriation of capital requires RBI permission.
1980-90	FERA continued to remain the base of Foreign investment policy. FI allowed in 25 industry groups and in others only in "backward areas". Entry procedures simplified. Direct application is allowed even before choosing the Indian partner	Remained the same But steps were taken to augment FI from developed countries through fast clearance channels	---	Outward remittance of dividends, technical fees, royalties made easy	Repatriation of capital with RBI permission
1991-99	FERA diluted drastically. Entry allowed in all but Annexure-I (comprising 5) industries through FIPB/ RBI	1. Upto 24% in SSI 2. Upto 50% in mining 3. Upto 51% in 13 industries 4. Upto 74% in 9 industries 5. Upto 100% in Key sectors. EPZs/EOUs Fully owned subsidiaries allowed in any industry on a case to case basis, by FIPB	Dividend balancing in 22 groups of Consumer Goods Industries	1. Use of brand name/trade marks allowed 2. No need for local partner 3. Repatriation of capital, profits and dividend allowed 4. Above all, non discrimination and national treatment, signatory of MIGA	Disinvestment is permitted as per the terms of letter of approval granted

* FI = Foreign Investment

Source : Various Official Sources

19.7 FOREIGN CAPITAL & COLLABORATIONS : 1991-99

India's liberalisation of foreign investment policy in the 90s has been attracting the attention of foreign investors all around the world. India's image as an investment destination for foreign capital has taken a positive upturn in the process. There has been a dramatic increase in the number of foreign collaborations approved through different channels during 1991-99. The specially created FIPB has been the most preferred channel for foreign investors to get approval for their proposals (Table 19.4).

Table-19.4
FOREIGN COLLABORATION APPROVALS IN THE 90S

Channel	1991	1992	1993	1994	1995	1996	1997	1998	1999*
SIA	760	585	307	382	593	410	167	193	52
RBI	188	736	676	702	799	719	801	432	307
FIPB	2	199	493	770	945	1174	1357	1161	608
Total	950	1520	1476	1854	2337	2303	2325	1786	967

* Upto 30th June 1999

Source : SIA Newsletter, July 1999.

As a result, there has been a dramatic increase in the amount of foreign investment approved in the 90s. The foreign investment approval was Rs. 5.3 billion in 1991. But it went up steadily to Rs. 548.9 billion in 1997 (Table 19.5). Of course, there was a sharp decline in the amount of foreign investment approved in 1998 but this could be due to the world recession and particularly the South East Asian economic crisis. In 1999, however, foreign investment approval seems to be again on the rising path.

The channels of foreign investment shows that FIPB has been instrumental in the rapid increase of foreign investment approved in the 90s (Table 19.5). During 1991-90, more than 90 percent of the total foreign investment has been approved by FIPB.

Table-19.5
FOREIGN INVESTMENT APPROVED : 1991-90

Year	SIA	RBI	FIPB	Total
1991	3.6	1.4	0.3	5.3
1992	4.2	7.8	26.9	38.9
1993	1.6	6.6	80.4	88.6
1994	3.2	5.3	133.4	141.9
1995	3.0	5.4	312.3	320.7
1996	11.8	12.5	337.2	361.5
1997	3.2	92.7	453.0	548.9
1998	7.2	1.9	299.0	308.1
1999*	0.0	5.8	156.6	162.4

*Upto 30th June 1999

one billion = 100 crore.

Source : Newsletter, July 1999.

The composition of foreign collaborations approved during 1991-99, reveals that technical collaborations accounted for a considerable majority in the initial two years (Table 19.6). But the number of financial collaborations increased consistently from year to year till 1997. (As a result, the ratio of financial to technical collaboration changed from 70:30 in 1991 to 28:72 in 1997). Though the number of financial collaborations declined in 1998, the ratio of financial to technical collaborations remained more or less the same. In 1999, the number of financial collaborations is again on the upswing, absolutely as well as relative to technical collaborations.

Table-19.6

Foreign Investment & Technical Collaboration Approvals : 1991-99

Year	Technical Collaboration	Financial Collaboration	Ratio of T.C. to F.C.
1991	661	289	70:30
1992	828	692	55:45
1993	691	785	47:53
1994	792	1062	43:57
1995	982	1355	42:58
1996	744	1559	32:68
1997	660	1665	28:72
1998	595	1191	33:67
1999*	215	752	22:78

* Upto 30th June 1999.

Source : SIA Newsletter, July 1999.

The sector wise distribution of foreign investment approvals shows that, foreign investment is likely to flow into diversified sectors of Indian economy (Table 19.7). As it appears, it is the much needed infrastructure sectors such as power, oil and telecommunication which have attracted bulk of the foreign investment approved during 1991-99: fuels and telecommunications together accounted almost 50 percent of the foreign investment approved. The other important sectors which account for a significant share of approved investments are transportation industry consisting of passenger cars, automobile industry and auto ancillaries, service sector comprising banking and non banking financial services, hospitals, etc., metallurgical industries, chemicals, electrical equipment and food processing industries. The foreign technical collaborations are also as diversified between sectors as that of foreign financial collaborations.

The foreign investment proposals are flowing into the country from different parts of the world - developed as well as developing. Unlike in the pre-liberalisation period, foreign investment

proposals emerge not only from OECD countries but also from NIEs (South Korea, Singapore, Hongkong and Taiwan), prominent South East Asian countries such as Malaysia and Thailand, etc. (Table-19.8). During 1991-99, India has approved foreign investment from as many as 90 countries. This is the testimony for the fact that India's liberal foreign investment policy has been attracting foreign investors from all around the world.

Table-19.7

**Foreign Investment and Technical Collaborations Approved (1991-99) :
Sector - Wise Distribution**

Sl. No.	Sector	Technical	Financial	Total	Amount of	% of total
1.	Fuels (power, oil, refinery, etc.)	170	411	581	618.48	31.31
2.	Telecommunications	111	406	517	358.30	18.14
3.	Transportation Industry	465	528	993	141.97	7.19
4.	Service Sector (Financial, banking, non-banking financial, hospital etc.)	39	631	670	120.31	6.09
5.	Metallurgical Industries (ferrous, non-ferrous, special alloys, mining etc.)	302	259	561	118.96	6.02
6.	Chemicals (other than fertilisers)	718	705	1423	114.77	5.81
7.	Electrical Equipment Industries	1016	1648	2664	109.21	5.53
8.	Food Processing Industries	138	584	722	84.23	4.26
9.	Others	2980	4091	7071	309.12	15.65
	Total	5939	9263	15202	1975.35	100.00

Source : Newsletter, July 1999.

Table-19.8
Origin of Foreign Capital : 1991-99

(Rs. Billion)

Home Country	1991-99	% to Total
U.S.A.	433.35	22.44
Mauritius	208.96	10.58
U.K.	141.72	7.17
South Korea	91.64	4.64
Japan	85.52	4.33
Germany	76.55	3.88
Australia	59.25	3.00
Malaysia	54.55	2.76
France	48.22	2.44
Israel	42.27	2.14
Other Countries (79 Countries)	723.32	36.62
Total	1975.35	100.00

Source : Newsletter, July 1999.

However, what is important is not the amount of foreign investment approved but the actual inflow of foreign investment. A foreign investment proposal indicates only the intention of foreign investor to invest in India. Even if the proposal is approved, it need not be followed by actual investment. At times, bureaucratic procedures, red tapism and infrastructural bottlenecks, etc. may discourage an investor to carry out his investment plans. Therefore, the actual flow of foreign capital in the 90s is a more appropriate indicator of foreign investors' response to India's liberalisation.

The actual inflow of foreign investment has also increased significantly in the 90s (Table-19.9). Till 1997, the increase was steady and consistent. In 1998, the flow declined some what, which could be due to the recession in the world market and more importantly, the South East Asian economic crisis.

Table-19.9

ACTUAL INFLOW OF FOREIGN CAPITAL : 1991-99

Year	Amount
1991	3.51
1992	6.75
1993	17.87
1994	32.89
1995	68.20
1996	103.89
1997	164.26
1998	133.40
1999	66.05
Total	596.82

Source : Newsletter, July 1999.

An important objective of foreign investment policy to enable foreign capital to supplement domestic capital formation, it would be appropriate to know to what extent foreign investment supplements domestic investment. Foreign investment accounted for a negligible share of India's gross capital formation or investment in 1991-92 (Table 19.10). However, since then, the share of foreign investment in total capital formation has increased continuously. In 1997-98, actual foreign investment inflow formed more than three percent of India's gross capital formation. However, it is too insignificant to make any impact on the economy.

Table-19.10

FDI and Domestic Capital Formation : 1991-97

(Rs. Crore)

Year	FDI (actual)	Gross Capital Formation (GCF)	FDI as % of G.C.F.
1991-92	351	144628	0.24
1992-93	675	169041	0.40
1993-94	1786	196379	0.91
1994-95	3009	263415	1.14
1995-96	6720	314340	2.14
1996-97	8431	361687	2.33
1997-98	12085	387377	3.12

Sources : Economic Survey, 1998-99

An international comparison projects India as a peripheral investment destination for foreign investors (Table 19.11). However, since 1991 there has been a gradual and steady, though marginal, increase in India's share of foreign capital as a percentage of foreign investment in Asia, developing countries and the world.

Table-19.11

FDI Inflows - India, Asia, Developing Countries And the World

(U.S. \$ Million)

Country/Region	1989	1990	1991	1992	1993	1994	1995	1996
I. India	252	236	155	233	574	1314	1929	2587
II. Asia	16021	23083	23129	29632	50924	57507	65249	84283
III. Developing Countries	28622	34689	41696	49625	73045	90462	96330	128741
IV. World	200612	211425	158936	173761	218094	238738	316524	349227
I as % of II	1.57	1.02	0.67	0.79	1.13	2.28	2.96	3.07
I as % of III	0.88	0.68	0.37	0.47	0.79	1.45	2.00	2.01
I as % of IV	0.13	0.11	0.10	0.13	0.26	0.55	0.61	0.74

Sources : World Investment Report, 1997.

All these imply that though the rapid rise in foreign investment inflow in the 90s indicates growing attraction of India as an investment destination internationally, its relative share in India's capital formation as well as global FDI inflow has been only minimum so far. India should take some urgent steps to augment the flow of foreign capital into the country. One major factor that hinders the flow of foreign capital is the procedural bottlenecks in the process of project implementation. The process of realisation of foreign investment approvals into actual inflow may be quickened if the pace at which the Government grants approvals to foreign investment proposals is extended to project implementation phase as well.

Policy transparency is another important issue. Though the overall policy has clearly demarcated the economic activities according to the scope provided for foreign capital, some of the sector specific policies have been either vague (eg : telecommunications) or have not been adhered to by the Government (eg : foreign private sector entry into civil aviation).

Finally, infrastructural bottlenecks have been cited as another reason discouraging foreign investors to come to India. The standard of transportation and telecommunication network is far from satisfactory as compared to even the Newly Industrialising countries.

Therefore, to attract foreign capital in a significant quantity, India must (i) remove procedural bottlenecks, (ii) formulate and implement transparent policies in minute detail, and (iii) develop infrastructure to make it comparable, at least, to the standard of Asian Tigers.

Activity-A :

Comment on the latest FIP of Government of India.

19.8 SUMMARY

The major objectives of foreign investment policy in India have been to (1) acquire technology, and (2) increase domestic investment. But to ensure that foreign capital did not hurt domestic economic interests, India went for a restrictive approach for foreign capital and collaborations during 1948-90. As a result, foreign capital inflow decreased and foreign technical collaborations did not help Indian industry in any significant manner, to improve its competitiveness.

But the process of economic reforms since 1991, comprising among others, the liberalised foreign investment policy has been successfully transforming the image of India as a destination for foreign capital. India has been consistently attracting more and more foreign capital & technical collaborations from year to year, with the exception of 1998. The foreign capital has been flowing into the diverse sectors of Indian economy, particularly, infrastructure, from all around the world to different regions of the country. More transparency into sector specific policies, measures to facilitate quick project implementation and infrastructure development as a priority will help India to attract foreign capital and state-of-the-art technology in a considerable manner in the coming years.

19.9 SELF-ASSESSMENT TEST

1. Analyse the merits and de-merits of promoting foreign capital and collaborations in a developing country.
 2. "Foreign financial collaborations are likely to worsen the balance of payments of a developing country much more than foreign technical collaborations. Do you agree? Why?"
 3. What are the major objectives of India's foreign investment policy? Given the objectives, what are the different phases of the foreign investment policy?
 4. What were the major features of India's foreign investment policy during 1948-90? What kind of impact it had on Indian economy?
 5. How India's foreign investment policy has been liberalised in the 90s? What are its implications and impact?
 6. "Liberalisation of entry conditions and equity restrictions are the highlights of India's foreign investment policy in the 90s". Is it true? Examine.
 7. Despite radical reforms and consistent increase in the inflow of foreign capital, India's relative position in Asia or the world has not altered significantly. What more measures would you suggest to make India a major investment destination for foreign investors?
-

19.10 FURTHER READINGS

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BRAOU

UNIT - 20 : MULTINATIONAL CORPORATIONS

Objectives

This unit will help you to understand:

- importance of Multinational Corporations
- definition and kinds of MNCs
- motives for foreign investments of MNCs
- theories which explains MNC activities
- the process of evolution of a MNC firm
- the functional strategies of MNCs
- the scenario of MNCs in the mid-90s.

Structure

- 20.1 Introduction
- 20.2 MNCs: Definition and Characteristics
- 20.3 Main Types of Foreign Production
- 20.4 Determinants of MNC Activity
- 20.5 The Process of Internationalisation of a Firm
- 20.6 Functional Strategies of MNCs
- 20.7 MNCs Structure & Features
- 20.8 Summary
- 20.9 Self - Assessment Test
- 20.10 Further Readings

20.1 INTRODUCTION

Multinational Corporations (MNCs) or Transnational Corporations (TNCs) are an outstanding feature of modern day industrialisation. MNCs own, control and have access to vast resources of capital, technology, marketing expertise, and sophisticated management techniques. Therefore, they have been looked at as a means of supplementing capital, acquiring technology, for facilitating the transfer of skills and penetrating international markets by countries across the globe, particularly developing countries.

At the same time, MNCs have also been accused of many things in the past; specially in the 60s and 70s; they represent the unacceptable face of capitalism, they are huge, ruthless and stateless, and these firms would exploit the poor, manipulate governments and flout popular opinion. However, since the 80s, opinion and perception about MNCs have been changing. Governments have been lowering trade barriers and restrictions foreign investment are consistently diminishing. Governments everywhere, particularly in the developing world, regard multinationals not as predators to be avoided but as sources of investment, technology and above all jobs.

As a result, internationalisation of business and emergence and growth of MNCs have become the major trends of industrialisation in the 80s and 90s. In fact, cross border business has been driven forward by three main things (1) falling regulatory barriers to overseas investment, (2) tumbling telecommunication and transport costs, and (3) free domestic and international capital markets in which companies can be bought, and currency and other risks can be controlled. All these have made it easier for companies to invest where they choose to do so more cheaply and with less risk, resulting in rapid growth of multinational investments and production.

20.2 MNCs : DEFINITION AND CHARACTERISTICS

A multinational or transnational enterprise is an enterprise that engages in foreign direct investment (FDI) and owns or controls value-adding activities in more than one country. This is the threshold definition of a multinational enterprise and one that is widely accepted by agencies such as the Organisation for Economic Co-operation and Development (OECD), the United Nations Centre on Transnational Corporations (UNCTC) and by most national governments. However, different authors have defined MNC in different ways. According to Prof. Vernon, "MNC is a cluster of corporations of diverse nationality joined together by a common management strategy".

Professor Jack Behrman, on the other hand, emphasises that the essential characteristic of multinational enterprises is the attempt to treat various national markets as one, to the extent that this is permitted by governments. Professor Kolde defines a multinational enterprise as a "number of affiliated business establishments which function simultaneously in different countries". All these definitions emphasise the internationalisation of business of an enterprise.

There are several criteria for assessing the degree of an enterprise's multi or transnationality. These include:

1. the number and size of foreign subsidiaries or associate companies it owns or controls
2. the number of countries in which it engages in value-adding activities such as mines, plantations, factories, selling outlets, banks offices and hotels
3. the proportion of its global assets, revenue, income or employment accounted for by its foreign affiliates
4. the degree to which its management or stock ownership internationalised
5. the extent to which its higher value activities, for eg. R&D, are internationalised; this measure is intended to capture the quality or depth of foreign production
6. the extent and pattern of the systematic advantages arising from its governance of, and influence over a network of economic activities located in different countries.

Each of these criteria helps to delineate different types of international production. This is because the multi or transnationality of an enterprise is best considered as a multidimensional rather than a uni-dimensional concept.

A MNC has two distinctive features. First, it organises and coordinates multiple value adding activities across national boundaries and second, it internalises the cross-border markets for the intermediate products arising from these activities. No other institution engages in both cross-border production and transactions.

A MNC may be privately or publicly (i.e. state) owned and managed. It may originate from an industrialised or a developing country. It may be a large diversified global corporation owning or managing a network or coalition of activities in many countries or a small, single-product firm that operates only one foreign marketing venture. Its assets may be owned and controlled by citizens or institutions of a single country. (eg: Virgin Atlantic, Mars) nationally

controlled but internationally managed and owned: (eg: Ford, Sony, etc.) or internationally owned and controlled (eg: Agfa-Gevaert, Royal Dutch Shell, etc.). In practice, most MNCs are nationally controlled but internationally owned, although the extent and form of their cross-border equity and non-equity participation may vary greatly between industries and firms, and even within the same firm over time.

20.3 MAIN TYPES OF FOREIGN PRODUCTION

Broadly, there are four types of MNC activity: (1) Natural resource seekers, (2) Market seekers, (3) Efficiency seekers, and (4) Strategic asset or capability seekers.

The objective of foreign production engaged by MNC may vary from industry to industry and from time to time. In the 90s, many of the larger MNCs are pursuing multiple objectives, and most engage in foreign direct investment that combines the characteristics of each of the above categories. Further, each type of foreign production of a MNC may be aggressive in the sense that the investing company is seeking to take pro-active action to advance its strategic objectives, or defensive in the sense that its behavior is in reaction to actions taken by its competitors or by foreign governments which force it to protect its market position.

Natural Resource Seekers :

These include those MNCs which are promoted to invest abroad to acquire particular and specific resources at a lower real cost than could be obtained in their home country. The objective is to make the investing enterprise more profitable and competitive in the market it services than it would otherwise be. In the case of such enterprises, mostly located in developing countries, they export most or all of their output to industrialised countries.

There are three types of resource seekers. Firstly, there are those which seek physical resources. They include primary producers and manufacturing enterprises from both developed and developing countries. They seek resources such as mines and minerals, agricultural and plantation products, raw materials, etc. the utilisation of which requires capabilities possessed by the MNC firms. Some foreign investment of MNCs in service activities also intend to exploit location-bound resources, eg: tourism, oil drilling, etc. Many MNCs in the food-processing industry, oil drilling & exploration, mining, plantations, etc. fall in this category.

The second group of resource seeking MNCs include those which seek potential supplies of cheap and well motivated unskilled or skilled labour. This kind of foreign production is generally undertaken by manufacturing and service MNCs from countries with high labor costs, in countries with lower labour costs, to supply labour intensive intermediate or final product for export. Eg: MNCs in the garment industry set up units in Asian countries to make use of cheap labour. Similarly, Multinational software firms set up subsidiaries in India mainly to take advantage of the relatively cheap software professionals available in plenty in the country.

The third type of resource seekers aim acquiring technological capability, management or marketing expertise and organisational skills. Eg. Technological collaborations entered into, by Korean, Taiwanese and Indian firms with European, Japanese and U.S. firms in high technology sectors, executive search subsidiaries set up by U.S. firms in the U.K. etc. Most of the foreign production engaged by MNCs of Europe, U.S and Japan in the 19th century was prompted by the need to secure an economic and reliable source of minerals and primary products. Upto WW II, about 60 percent of the investments of MNCs was of this kind. But, since then, resource seeking MNC investments have declined gradually.

Market Seekers:

Market seeking MNCs invest in a particular country or region to supply goods or services to markets in these or in adjacent countries. In many cases, most of these markets would have

been earlier covered by exports from the investing company. However, due to tariff or other cost-raising barriers imposed by host countries or due to the expanded market size, these firms could find local production as the most profitable and feasible alternative to exports.

Market seeking investments may take place either to protect existing markets or to promote new markets. There are four major factors which influence MNCs to indulge in market seeking investments:

1. Main suppliers or customers of MNCs would have set up foreign producing facilities and that to retain their business they need to follow their suppliers / customers overseas. Eg: Recently about 300 Japanese auto-component suppliers have set up manufacturing subsidiaries in the U.S. in order to supply U.S. based plants of the leading Japanese auto assemblers.
2. It may require that products need to be adapted to local tastes or needs, and to indigenous resources and capabilities. Further, to have familiarity with local language, customs, legal requirements and marketing system, etc. may necessitate foreign companies to establish their own subsidiaries in different countries or else they will be at a disadvantage vis-a-vis local firms. This will be particularly true in the case of consumer goods like washing machines, food and drink products, electronic goods financial and professional services.
3. The production of goods that are relatively costly to transport and can be produced economically in small quantities is more likely to be located near the main centres of consumption than are those that cost relatively little to transport and yield substantial economies of scale in production. In some cases, government regulations or import controls may prompt firms to relocate their production facilities.
4. The increasingly important reason why MNCs go for market seeking investment is that they may find it necessary, as part of their global production and marketing strategy, to have a physical presence in the leading markets served by its competitors.

Unlike those engaged in other kinds of foreign production, market seeking MNCs tend to treat their foreign affiliates as self-contained production units rather than as part of an integrated net work of cross-border activities.

As a result, they tend to be most responsive to local needs and requirements. At the late 80s market seeking investments of MNCs accounted for about 45 percent of the global foreign direct investment.

Efficiency Seekers

Efficiency seeking investments refer to those investments undertaken by MNCs to rationalise the structure of established resource based or market seeking investment in such a way that the investing firms gain from the common governance of geographically dispersed activities. Such gains emerge from economies of scale and scope and risk diversification. The objective is to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and market structure by concentrating production in limited locations to cater to various markets.

Efficiency seeking MNCs are usually well established and experienced, large and diversified in nature. Efficiency seeking investments will flourish only when cross-border markets are well developed and open.

Efficiency seeking MNCs are of two kinds :

1. Those investments which take advantage of differences in the availability and cost of traditional factor endowments in different countries. This explains why capital-cum-technology intensive MNCs are more concentrated in developed countries and labour and natural resource intensive activities of MNCs are concentrated in developing countries.
2. Those investments which take place in countries with broadly similar economic structures and income levels. It is aimed at gaining from the economies of scale and scope, and of differences in consumer tastes and supply capabilities.

Strategic Asset Seekers

These include those MNCs which engage in foreign investment usually by acquiring the assets of foreign corporations to promote their long-term strategic objectives, especially that of sustaining or advancing their international competitiveness. The basic objective is not to tap the specific cost or marketing advantages but to add to the acquiring firm's existing assets, to sustain or strengthen their overall competitive position or weaken that of their competitors.

Eg: One MNC may acquire or engage in a collaborative alliance with another to thwart a competition from doing so. Another might merge with one of its foreign rivals to strengthen their joint capabilities as against a more powerful foreign rival. Yet another MNC might acquire a group of suppliers to corner the market for a particular raw material. Still another MNC might enter into a joint venture with a domestic company to understand the local market and fight out its long established MNC rival. These are examples for strategic asset seeking MNCs who aim at protecting or enhancing their own competitiveness in the long run.

In addition to the above described four major motives of foreign production, there are three other less important motives: (i) Escape investments, (ii) Support investment, and (iii) Passive investments.

Escape Investments :

Some firms resort to foreign investment to escape home country's restrictive legislation or macro-organisational policies. Some Indian companies have gone for foreign investments in the 70s and 80s mainly because MRTP Act obstructed them from investing further in India. Some Israeli firms invested in Europe to bypass Arab boycott on products exported from Israel. Some chemical industry MNCs shifted their operations from Western countries to developing countries, to avoid stringent environmental laws back home.

Escape investments are likely to originate in response to controls and regulations and are likely to be concentrated in those sectors which are most regulated.

Support Investments :

These are incurred to support the activities of the rest of the enterprise of which they are part. Such affiliates are generally not self-contained profit centres. Such activities bring major benefits to the rest of the MNC operations. Eg: Investments made by TVS in Sri Lanka to develop a chain of service centres, trading companies set up by MNCs for purchase of raw materials and sale of finished goods in different foreign locations. Branch or regional offices of MNCs which recruit manpower, conduct investment feasibility studies, site selection, liaison with host governments and / or regional authorities are other examples.

Passive Investments

Most direct foreign investments vary in the degree of active management pursued by the owners, ranging from "complete" to "non-existent".

Those which veer to the passive end of the spectrum are of two kinds:

1. Investments made on foreign assets, particularly real estate by companies. It is based on future land and property values. The motivation of such investment may be primarily financial. Eg: majority of Arab investments in London hotel in the 70s was of this kind.
2. Investment made by Small firms and individual investors in real estate. The objective is to have holiday or second homes in foreign countries. It will involve only passive ownership rather than active management.

Thus, MNCs resort to foreign investment for various reasons. It may be to acquire resources, to cater to local markets, to improve their own efficiency or long term competitiveness, to escape stringent domestic regulations, to support their own mainline manufacturing activities or even to speculate and gain in the subsequent periods.

20.4 DETERMINANTS OF MNC ACTIVITY

Several theories have been developed to explain the determinants of international production of MNCs. Of them, the significant ones are those propounded by (i) Stephen Hymer, (ii) Product cycle hypotheses of Raymond Vernon, (iii) internationalisation theory, and (iv) eclectic paradigm. According to Hymer, MNC firms possess some kind of innovatory, cost, financial or marketing advantages which are specific to their ownership and out weigh the disadvantages they faced in competing with indigenous firms in the country of production. It is these advantages which are assumed to be exclusive to MNC firms, and which represent some kind of structural market failure, promote them to go for international production.

Raymond Vernon used a micro economic concept - the product cycle - to explain a macro economic phenomenon, i.e., the foreign manufacturing activities of U.S. MNCs in the post-war period. According to him, in addition to natural and human resources, the firms will have exclusive technological capability to upgrade these assets or to create new ones. Initially, these firms produce new products for the home market in the home country near to both its innovatory activities and markets. At a later stage of the product cycle, because of a favourable combination of innovating and production advantages, firms export these products to other countries most similar to the home country in demand patterns and supply capabilities.

Gradually, as the product becomes standardised and competitors emerge, the competitive advantages of MNCs diminish. This results in pressure to ensure cost efficiency. Further, as demand becomes more price elastic and as foreign markets expand, the attractions of starting manufacturing operations in foreign markets rather than in a domestic market, increase. If the policies of the foreign countries are favourable, then MNCs set up subsidiaries for local production to replace exports. This in, brief, is the product cycle hypotheses of Vernon. But it explained only the market seeking investments of MNCs and not resource efficiency or strategic asset seeking investments.

Internalisation theory is primarily concerned with identifying situations in which markets for intermediate products are likely to be internalised by MNC firms. Its basic hypothesis is that multinationals represent an alternative mechanism for arranging value-added activities across national boundaries to that of the market that MNC firms are likely to engage in foreign investment whenever they perceive that the net benefits of their joint ownership of domestic and foreign activities, and the transactions arising from them, are likely to exceed those offered by external trading relationships. Internalisation theory may be considered a general theory as it aims to predict the situations in which firms choose to internalise foreign markets.

But it is the eclectic paradigm which seeks to offer a general framework for determining the extent and pattern of both foreign owned production undertaken by a country's own enterprises

and also that of domestic production owned by foreign enterprises. Unlike internalisation theory, it is not a theory of the MNC per se, but rather of the activities of enterprises engaging in cross-border value-adding activities.

According to the eclectic paradigm, the level and structure of firm's foreign value-adding activities will depend on four conditions.

1. A firm must possess sustainable ownership - specific (O) advantages vis-a-vis firms of other nationalities in the particular markets it serves. These O advantages may include intangible assets as well as those which arise out of the common governance of cross-border value added activities. The use of these advantages are assumed to increase wealth creating capacity of the firm.
2. The firm possessing O advantages must perceive that is in its best interest to add value to its O advantages rather than to sell them (in O advantages) to foreign firms. This is done through acquiring assets in foreign locations and internalising (I) those foreign located manufacturing operations, within the firm. These advantages are called market internalisation (I) advantages.
3. The foreign locations/countries must possess some location specific advantages such as natural resources / skills, etc., which are scanty in supply in the home country. These are called location (L) advantages.
4. The configuration of the Ownership, Location and Internalisation (OLI) advantages facing a firm must be in conformity with its long-term management strategy.

Given these, at any given moment of time, the more a country's enterprises, relative to those of another, possess O advantages and there are foreign locations with L advantages, the greater the incentive they have to internalise rather than externalise their use, then the more they find it in their interest to exploit them from a foreign location and therefore, engage in foreign production. The paradigm can be expressed in a dynamic form as well. Changes in the outward or inward direct investment of a country can be explained in terms of changes in the O advantages of its enterprises relative to those of other nations, changes in its L assets relative to those of other countries, changes in the extent to which firms perceive that these assets are best organised internally rather than by the market, and changes in the strategy of firms which may affect their reaction to any given OLI configuration. Some of the OLI advantages for firms are given in Box 1.

Though none of these theories are comprehensive, these are the prominent ones among the many advanced to describe the evergrowing international production of multinational enterprises.

20.5 THE PROCESS OF INTERNATIONALISATION OF A FIRM

There are five major phases identified in the internationalisation process of a firm. It is not necessary that each and every multinational firm must have undergone all the five phases identified. While some firms may go through the five phases, others depending on their motives for foreign investment, may jump over one or more of the phases.

Box 1

The Eclectic Paradigm of International Production

1. Ownership - specific advantages (of an enterprise of one nationality over those of another)
 - (a) Intangible assets advantages (O_a) : the resource structure of the firm, product innovations, production management, innovatory capacity, noncommunicable knowledge, 'bank' of human capital experience, marketing, finance, etc.
 - (b) Advantages of common governance, that is, of organising with complementary assets (O_t) : Those resulting from size, product diversity and learning experiences of enterprises (eg: economies of scope and specialisation). Ability to obtain inputs on favoured terms (eg: as a result of size on monopolistic influence, etc.)
2. Internalisation incentive advantages (i.e. to circumvent or exploit market failure)
 - To avoid costs or broken contracts and ensuing litigation
 - To capture economies of interdependent activities
 - To avoid or exploit government intervention (quotas, tariffs, price controls, etc.)
 - Need of seller to protect quality of intermediate or final products, etc.
3. Location - specific variables (these may favour home or host countries)
 - distribution of natural resources and markets
 - input prices, quality and productivity
 - investment incentives and disincentives
 - artificial barriers to trade in goods and services
 - economic system and strategies of Government.

Source : Dunning, J.H. Multinational Enterprises and the Global Economy, 1993, p-81.

Phase 1 : A Firm's Initial Entry into Foreign Markets

By and large, firms initially engage in transactions across national boundaries, mainly for two reasons : (1) to acquire inputs at a lower cost or to prevent their competitors from accessing these inputs, and (2) to protect existing or seek new markets for their output. How a firm will enter into foreign production will depend upon the characteristics of the targeted market, the kinds of goods and services produced and traded, the market structures in which firms compete and the nature of cross border transactional mechanisms. This will be strongly influenced by country specific economic, legal, political, institutional and cultural considerations. Added to these, the technical capabilities and experience of foreign markets of firms will also be relevant.

Given all these, a firm may just open branch office to study the foreign market or find out appropriate investment avenues, or else locate its after sales - servicing network (Fig. 20.1.)

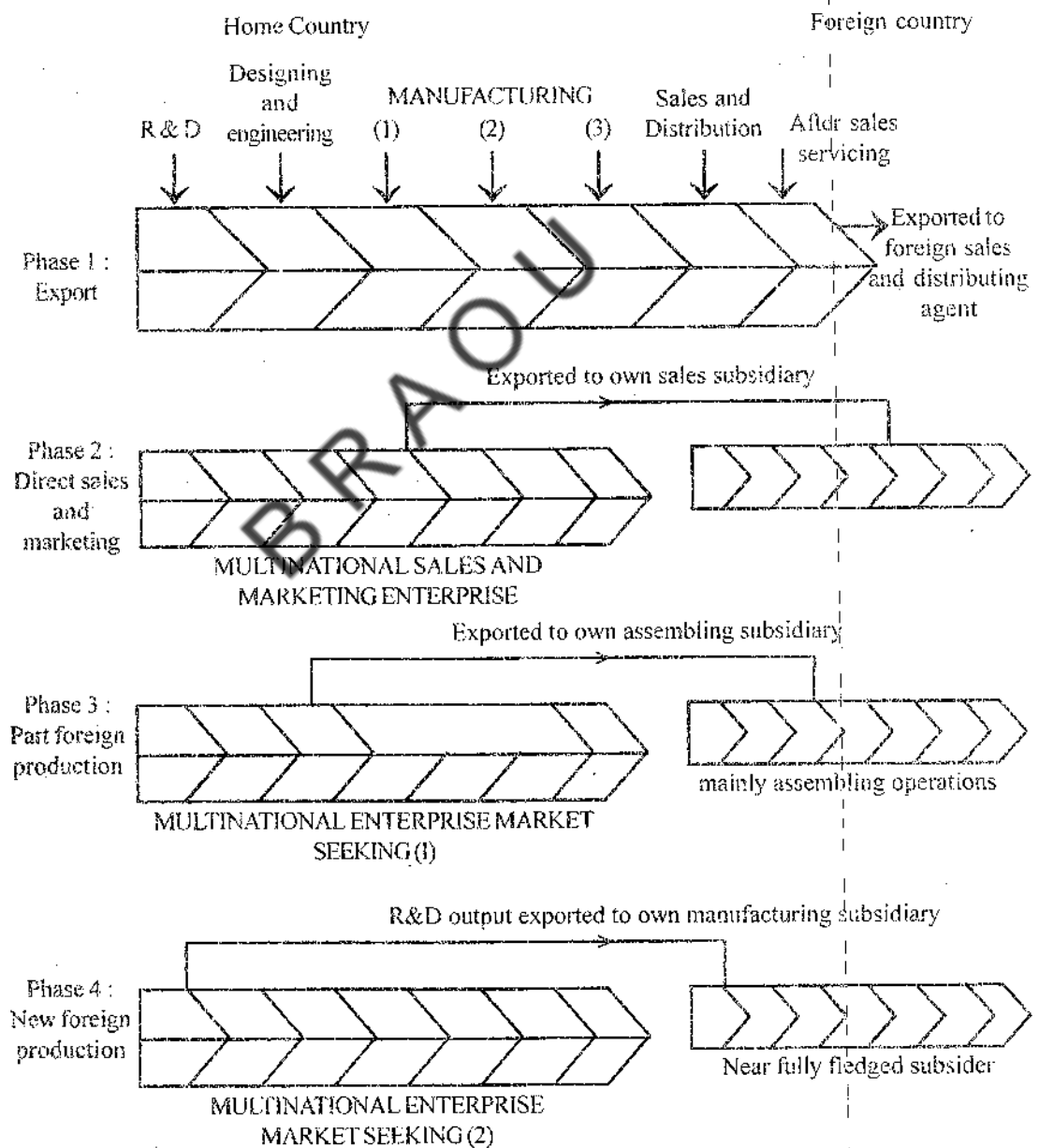
Phase 2: Investment in Trade Related Activities

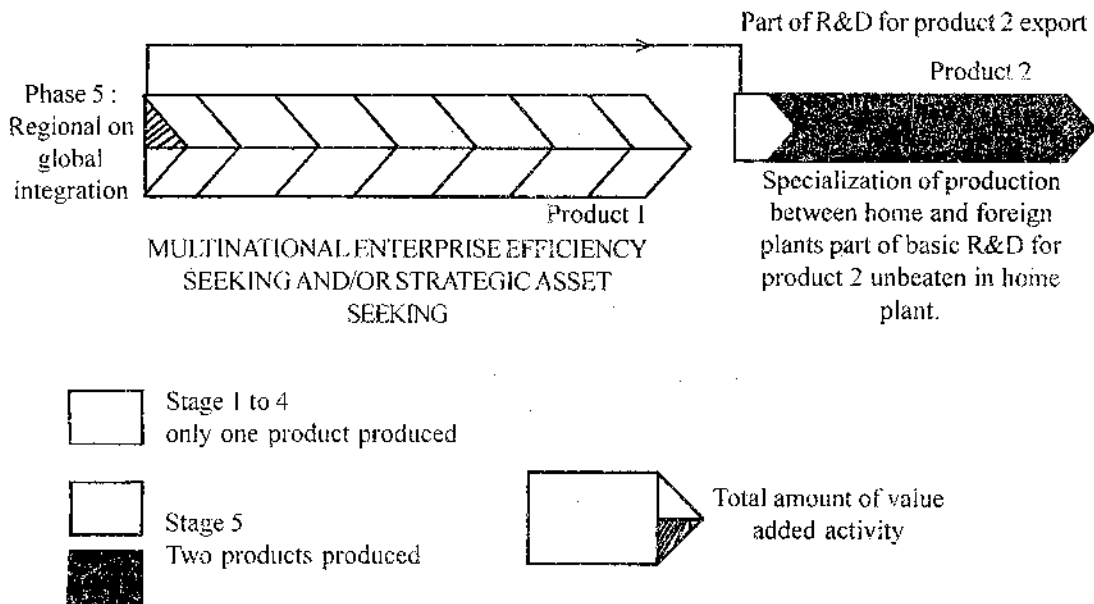
The second phase in internationalisation involves owning distribution and selling networks in foreign countries. The more familiar and experienced a firm is and the larger the buying and /or selling stake it has in a particular country, the more it will prefer to own its distribution and selling networks.

Trade and marketing related activities cover a wide spectrum of functions and a firm may choose different entry routes for organising different functions. For eg: a firm might subcontract advertising to a foreign firm while owning sales subsidiary outlets and after sales servicing centres (Figure 20.1).

The large European and U.S. Retail firms organise their own multinational buying outlets for their main product lines, but rely on overseas agents for others. The major international airline companies own their own maintenance and repair facilities at some imports in foreign countries but at others, they buy these services from independent local firms.

Figure - 20.1
Process of Internationalisation of Firm





Source : Dunning, J.H. *Multinational Enterprises and The Global Economy*, 1993, p-194

Phase 3 : Moving Forward or Backward Along the Value Chain

The firm is said to have entered the third phase when it engages in foreign production of goods and services, as opposed to facilitating the sale or purchase of goods and services already produced (Figure 20.1). A firm may transfer a particular part of the manufacturing process from home country to a foreign country. On the other hand, foreign production might supplement or be quite independent of domestic production. In any or all these cases, either a completely new value - added facility may be set up or an existing facility may be acquired.

Some firms may enter Phase 1 and move on to Phase 2 and then Phase 3. Where as some others might directly enter Phase 2 and /or move on to Phase 3. Thus, the present model assumes that there is a progression from the ownership of mainly transacting facilities to the ownership of both transacting and producing facilities.

However, once a firm enters Phase 3, it is not necessary that it should continue with its production facilities abroad. It may revert to Phase 2 or go for more intensive foreign production and thus move towards Phase 4.

Phase 4 : Deepening and Widening of the Value - Added Network

Most of the international production activities initiated by MNCs in the early stages of internationalisation will be usually at the final assembling or initial processing stage of the value adding chain. These require least investment in human competencies and physical capital and therefore, involve least risk.

But, if such investments prove successful and if and when markets expand, local supply capabilities improve or host governments offer more incentives, then more of the higher value added activities will be transferred from the home to the host country.

The sequential growth of MNCs many take several forms. It may be investments for higher value adding activities, or widening the range of products produced by its subsidiaries, especially where opportunities of economies of scope exist or even moving into other adjacent markets by setting up production bases. In short, if initial entry is successful, foreign production then creates its own momentum - promoting thereby, vertical/horizontal diversification.

Phase 5 : Towards the Regional or Global Integration of the Value Added Network

This stage signifies the advanced growth of a multinational firm. At this stage, a MNC firm widely distributes its value-adding activities between home and foreign countries. The parent and the subsidiary units produce different products, each of which is sold in world or regional markets and frequently traded between the parent MNC and its subsidiaries.

There are still comparatively very few MNCs that practice a globally integrated product / process strategy. A handful of MNCs that have evolved into this phase are Ford, Philips and IBM. But even these MNCs may not be prepared to allow the management of all their subsidiaries to participate in their decision making exercise, particularly regarding R&D.

20.6 FUNCTIONAL STRATEGIES OF MNCs

Given the motives and determinants of international production firms and the process of internationalisation, it is essential to understand their functional strategies adopted for international growth. There are three major strategies pursued by MNCs with reference to their value chain (Box 2) for international growth: (1) stand-alone strategies, (2) simple integration strategies, and (3) complex integration strategies (Box 3)

Box 2

Value Chain of a Firm

A firm's various functions can be described as comprising its value chain. A value chain describes how a firm organises and performs various activities that add value to the goods and services it produces and sells. Some of these activities are linked vertically and some horizontally.

Vertically linked activities include inbound logistics (eg: site selection), operations, outbound logistics (eg: movement of products), marketing and after sales services. Horizontally linked activities include HRM, R&D, Finance, Procurement, Accounting etc.

Although every firm performs all these functions, relative importance of each of these varies from company to company or product to product. For eg: Operations and after-sales services are more important in automobiles and consumer electronics than in food and soaps. Further for services firms, unlike that of manufacturing firms, operations include both production and consumption - since they take place together at the same item. The ability of a firm to identify and exploit those activities of the value chain that are more important is seen as a source of success.

The activities of the value chain can be linked in different ways and can be more or less, closely integrated. A firm's strategy, external environment, demand for its product, Government policies are all major determinants of the form and closeness of the linkages.

Source: World Investment Report, 1993

Box 3

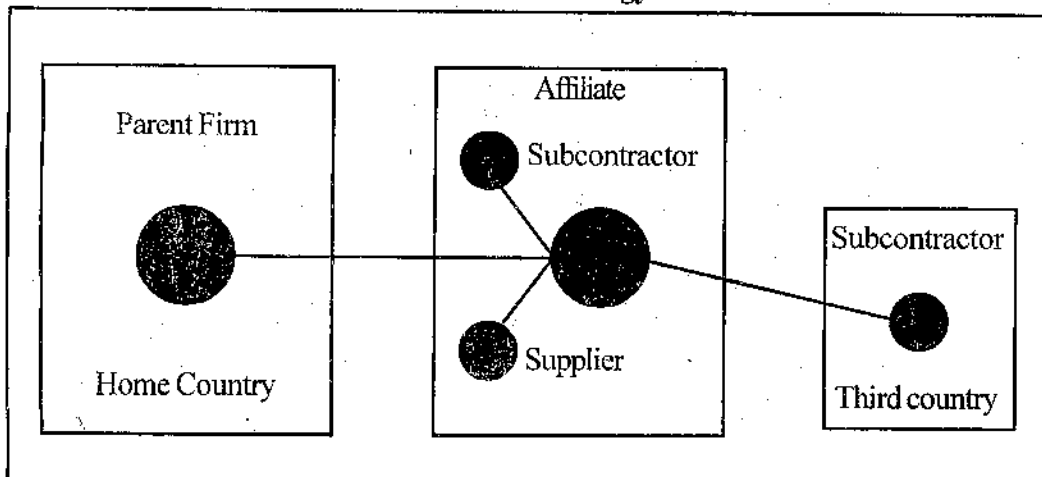
Evolution of the Strategies and Structures of Transnational Corporations

Form	Types of Intra-Firm Linkages	Degree of Integration	Environment
Stand-alone, eg : multi-domestic	Ownership, technology	Weak	Host country accessible to FDI; significant trade barriers; costly communications and transportation
Simple Integration,	Ownership, technology markets, finance, other inputs	Strong at some points of value chain, weak in others.	Open trade and FDI regime, at least bilaterally; non-equity arrangements.
Complex international production, eg: regional core networks	All functions	Potentially strong throughout value chain	Open trade and FDI regime; information technology; convergence in tastes; heightened competition

Stand alone Strategies

Stand alone strategy refers to affiliates of MNCs which operate largely as independent concerns within the host economy. The main link between a parent unit and its foreign affiliates is controlled through ownership, transfer of technology and supply of long-term capital. In general, a stand-alone affiliate is responsible for most of the functions of the value-chain and in turn, it may develop links with local suppliers and subcontractors. It may employ local workers, managers, borrow from local financial institutions and even export its products to other countries. A stand alone affiliate is nothing but a smaller version of the parent firm (Figure 20.2). Stand alone affiliates are particularly common in services since they are not tradable. Citi Bank, ANZ Grindlays Bank, Pepsi, Coca-Cola, Cadbury, etc. are all examples for stand-alone affiliates of MNCs in India

Figure-20.2
Stand Alone Strategy

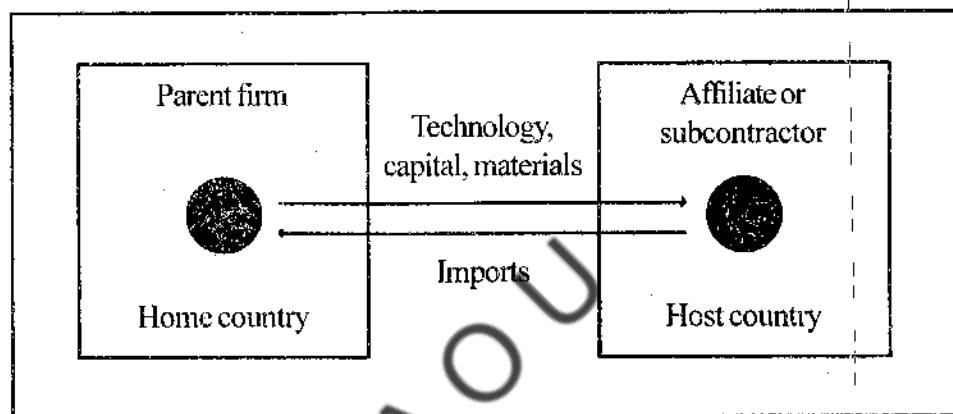


Source: World Investment Report, 1993

Simple Integration Strategies

Some MNCs report to international production by locating part of their value chain activities in different foreign countries. The primary objective of this strategy is to utilise the locational advantages of a host country with respect to a portion of the MNC's value chain. It is also called international production via outsourcing. The outsourced production is controlled by the parent MNC through ownership of the affiliates. These affiliates cannot function independently and are integrated into the parent firm's value chain through the establishment of functional linkages (Figure 20.3)

Figure-20.3
Simple Integration Strategy



Source: World Investment Report, 1993

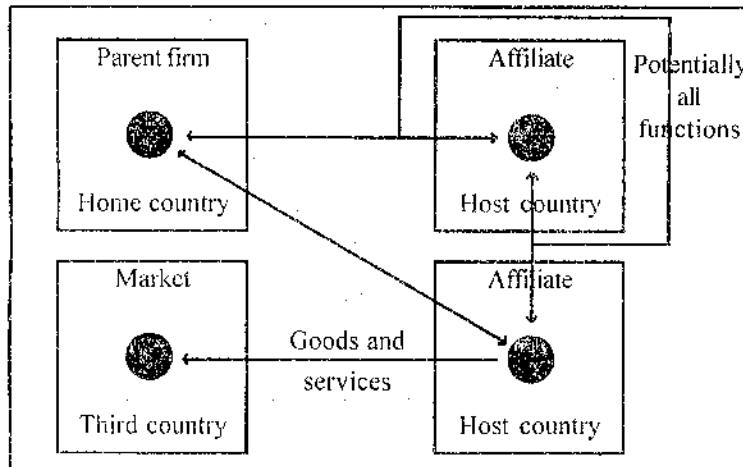
To a large extent, this strategy is cost-driven. Nike of the U.S. for eg.: subcontracts the manufacture of its athletic shoes and clothing to 40 separate locations, mostly in South and South - East Asia. Design and marketing are done by the parent firm, whereas shoe and cloth manufacturing is done by the subcontracting firms. The output is sold world-wide by the parent firm. Since individual sub-contractors are dependent upon the parent firm for design, standards and marketing they are not capable of standing alone.

In the liberalisation era, many MNCs are entering India to outsource part of their operations, particularly in software development, electronic components, readymade garments, etc.

Complex Integration Strategy

This strategy is based on a firm's ability to shift any of the functions related to manufacturing or service operations to anywhere in the world to its best advantage. Under complex integration, any affiliate operating anywhere may perform either by itself or with other affiliates or the parent firm, functions for the firm as a whole (Figure 20.4)

Figure-20.4
Complex Integration Strategy



Source : World Investment Report, 1993

Complex integration results out of a firm's actions of locating its various functional activities - manufacturing, accounting R&D, finance, etc. - in different parts of the world to fulfill the firm's overall objectives and strategy. The degree of integration and dispersal of activities of the value chain in terms of locations may vary from function to function, from time to time and from firm to firm.

Unilever has set up a R&D centre in Bangalore, Motorola has set up a paging R&D centre in Bangalore and Swiss Air has entrusted the responsibility of revenue accounting to its affiliate, Airline Financial Support Services India Pvt.Ltd., Mumbai as part of its overall cost-reduction and results enhancement programme. These are examples of complex integration strategy.

Three major factors have contributed to the emergence of complex integration strategies of MNC's (i) Advances in informatics and telecommunication - which have reduced time and costs of communication, (ii) cross national convergence of consumer taste with regard to clothes, electronic goods, food items, automobiles, etc. have led to considerable increase in consumer demand, and (iii) growing trend of liberalisation, particularly in developing world and socialist countries have resulted in intensifying competition world wide.

Given all these, what is important to know is the structural composition of multinational enterprise in the world today.

20.7 MNCs : STRUCTURE & FEATURES

MNCs are the major channels of foreign direct investment for any economy. By mid 1990s, there were almost 45,000 MNCs, with more than 275,000 affiliates across the world (Table 20.1). Of these, about 82 percent of the parent units were from the developed countries whereas hardly 18 percent were from the developing countries and rest from Central and Eastern Europe. But the origin of foreign affiliates presents a contrasting

Table - 1

**Number of Parent Corporations and Foreign Affiliates by Area and Country,
Latest Available Year**

Area / Economy	Year	Parent Corporations Based in Country	Foreign Affiliates Located in Economy
Developed Countries		36380	93628
Australia	1994	877	2205
Belgium	1996	152	2000
France	1995	2126	8682
Germany	1994	7292	11581
Italy	1995	966	1630
Netherlands	1993	1608	2259
Portugal	1996	1657	6671
Spain	1995	236	6232
Sweden	1996	3650	5371
United Kingdom	1992	1467	3894
Switzerland	1985	3000	4000
Japan	1995	3967	3405
United States	1994	3470	18608
Canada	1995	1691	4583
Developing Countries		7932	129771
Brazil	1994	797	9698
Chile	1995	---	2028
Columbia	1995	302	2220
Mexico	1993	---	8420
China	1993	379	45000
Hong Kong, China	1996	500	4604
India	1991	187	926
Indonesia	1995	313	3472
Korea, Republic of	1996	4806	3878
Philippines	1995	---	14802
Singapore	1994	---	19160
Taiwan Province of China	1990	---	5733
Central and Eastern Europe		196	53260
World		44508	276659

Source: UNCTAD

picture. MNCs of developed countries accounted for only 34 percent of the total foreign affiliates whereas MNCs of developing countries had a share of about 47 percent. This brings out that, on an average, a developing country MNC has more foreign affiliates than a developed country's MNC.

Among the developed countries, Germany, Japan, Sweden, U.S.A., Switzerland and France are the prominent ones, accounting for more than 2000 parent MNCs and more than 3500 foreign affiliates. Among the developing countries, South Korea is the most prominent one as it accounted for more than half of the total parent MNCs of developing world. Brazil, Columbia, China and Hong Kong are the other important countries of origin for parent MNCs. In terms of foreign affiliates, Chinese MNCs lead the developing world as they had more than one-third of the total foreign affiliates of developing countries.

Some of the top ranking MNCs in the world, in terms of foreign assets are Royal Dutch Shell, Ford, General Electronic Company, Exxon, Corporation, General Motors, Volkswagen AG, IBM, Toyota, Nestle SA, Mitsubishi, Bayer AG, ABB Nissan, etc.

Nearly 60 percent of the MNCs were in the manufacturing sector, 37 percent in the services sector and the rest in primary sector. Though the number of MNCs is increasing the assets of MNCs are highly concentrated in a few firms. The largest 10 MNCs controlled over one-quarter of the total assets of top 100 MNCs and a third of its foreign assets in the early 90s. In terms of industries, petroleum, automobile, chemical and pharmaceutical industries accounted for over half of the foreign assets of the largest 100 MNCs.

Activity-A:

What is the impact of MNCs on SSIs. Give an example.

20.8 SUMMARY

Growing trend of MNCs has become an important feature of industrialisation in recent decades, particularly in the 90s. MNCs are of various kinds and they own and control huge resources of capital, technology, marketing and management techniques which are crucial for rapid industrial development. Therefore, countries particularly in the developing world have been evolving favourable policies to attract as much MNC investments as possible.

MNCs may enter a particular country either for resources and markets or to improve their own efficiency or else to acquire some strategic assets to meet their long term objectives. However, where to invest, how much to invest and how to invest will largely depend on the advantage possessed by MNC firms as compared to others, the locational advantages of a particular economy and the advantages that will result out of owing and internalising foreign located operations.

Generally, a firm may become a MNC in gradual process—from exporting to trading in foreign countries to setting up assembly operations, etc. However, there may be firms who may directly go for setting up production units in a foreign country.

To become a multinational, a firm may adopt different functional strategies. It may set up an independent unit to produce goods in a foreign location or outsource a part of the production

process or locate different functions of the production process in different regions, to make as much gains as possible.

In fact, MNCs emerge from developed as well as developing countries, while the parent MNCs have largely emerged from the industrialised countries, a greater percentage of foreign affiliates have come up from developing country MNCs. Germany, Japan, Sweden, South Korea, Switzerland, France and U.S.A. are the bases for a majority of the parent MNCs. MNCs are largely concentrated in the manufacturing sector, followed by services and primary sector. Petroleum, automotive, chemical and pharmaceutical industries account for most of the largest MNCs and majority of the foreign assets of MNCs.

20.9 SELF-ASSESSMENT TEST

1. What is Multinational Corporation? Why has it assumed more importance in the 90s across the world?
2. What are the different kinds of MNCs? Why their motives differ?
3. "Resource seeking MNCs are more exploitative than the rest". Do you agree? Substantiate.
4. Describe the minor motives of MNC investments, with examples.
5. Why MNCs indulge in international production? What are the major determinants?
6. How eclectic paradigm is different from the rest of the theories of MNC activity?
7. Is it appropriate to generalise the internationalisation process of a firm? What are the different phases in internationalisation of a firm?
8. What is a value chain? What functional strategies MNCs adopt for their international production and growth? Analyse with examples.
9. Comment on the structure and composition of MNCs in the 90s. What are the major factors responsible for their rapid growth in the 90s? Examine.

20.10 FURTHER READINGS

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